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ABSTRACT

The purpose of this book is to help students understand why the U.S. Government is involved in the economy, the underlying social values that government tries to promote, and how U.S. economic decisions affect the global economy. It was designed to give them the background they need to form their own opinions about the role of government in the economy and how decisions made today will affect tomorrow's citizens. Chapter 1 explores the government's role in the economy, including government intervention, the Great Depression, the Post-World War II era, and "Reaganomics." Chapter 2 describes how government affects the economy. Topics include monetary policy, fiscal policy, and trade policy. Chapter 3 examines U.S. values and economic policy. Chapter 4 addresses the United States in the global economy, budget deficits, foreign competition, the domino effect, the shift toward a service economy, and the outlook for the future. The book contains numerous illustrations, graphs, and charts, and provides questions for further student research. (GEA)

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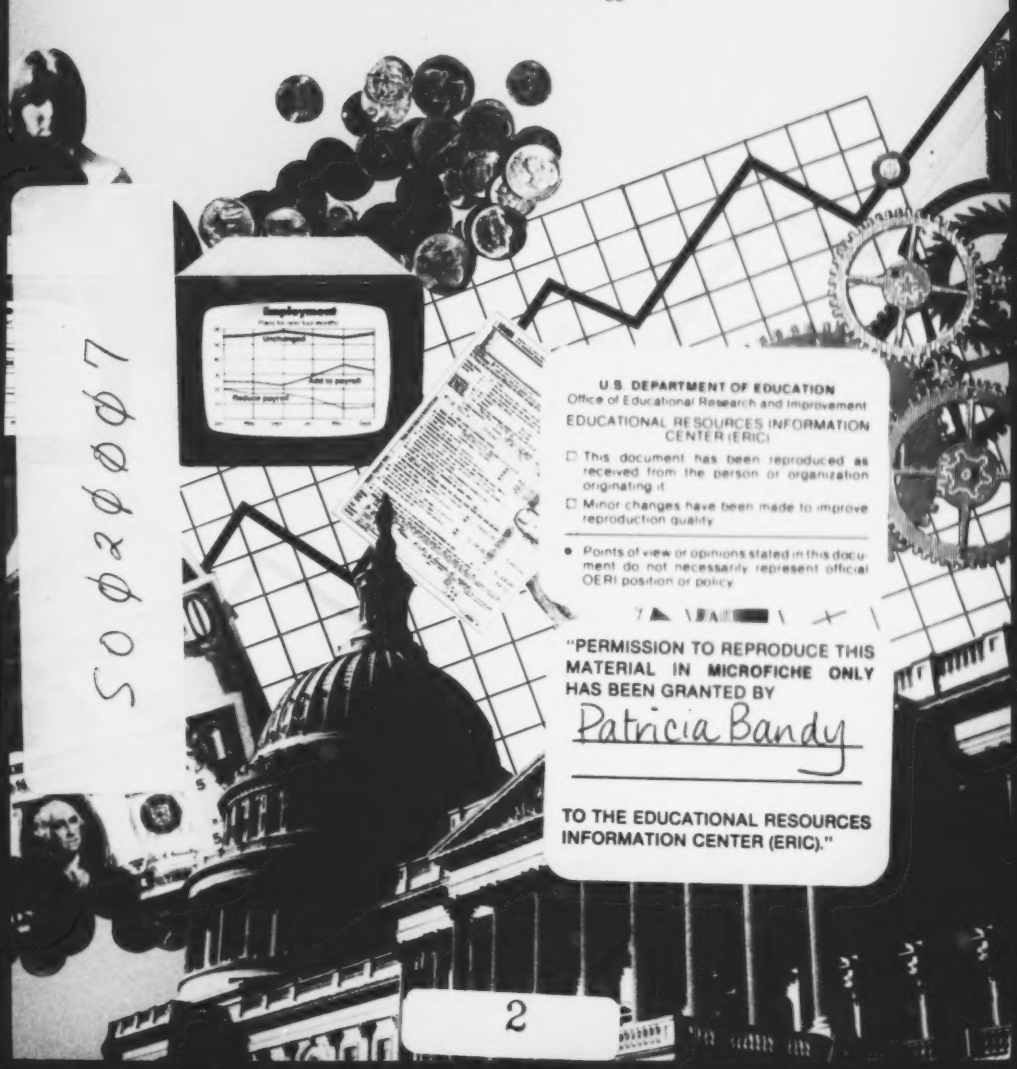
Economic Choices

Political Decisions That Affect You



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Economic Choices

Political Decisions That Affect You

Close Up Foundation

Economic Choices was developed by Joellen M. Fritsche, David R. Zack, and Joy Mara.

Publications Staff

Director of Publications:
Patricia Bandy

Managing Editor for Academic Publications:
Joellen M. Fritsche

Senior Writer:
David R. Zack

Writer:
John Carwile

Editorial Assistant:
Ann F. O'Malley

Photographers:
Renee Bouchard, Hilary Schwab

Manager, Art and Production:
Joan Petruska

Production Coordinator:
Rossanna Robertson

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Close Up Foundation

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The Close Up Foundation was established in 1970 to encourage high school students and their teachers to gain a better understanding of our government and their role as citizens.

Since that time, the Foundation has engaged in a variety of activities, from bringing students and teachers to Washington for weeklong government studies programs, to outreach efforts involving local programs, publications, older Americans, and cable and satellite technology.

The Close Up Foundation is a nonprofit and nonpartisan organization. It has no affiliation with any branch of government, political party, or interest group. Members of the Foundation's Board of Advisors hold a variety of political viewpoints and include representatives of both major political parties.

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Introduction

Why Should You Be Interested in the Government's Economic Decisions?

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else.

John Maynard Keynes

Government economic policies have an impact on every part of your life.

- How much money the government decides to withhold from your paycheck for income taxes dictates how much of your salary you get as cash in hand.
- How much money you pay in interest for a car loan is affected by the federal government, which influences the prevailing interest rate.
- How much money you pay for a shirt made in Hong Kong is affected by the federal government's trade agreements with that nation.

Government economic decisions involve more than just dollars and cents. They reflect the values that are important to us as a nation. For example, the government provides low-cost housing for the poor, regular income to retired people, and medical benefits to military personnel and their families. These programs mirror our belief in a society that provides for the poor, supports the elderly, and maintains a strong national defense.

Economic decisions are hard decisions. They are difficult for three reasons.

First, the government's resources are limited, and economic choices decide how we "divide the pie." For every value that Americans want to support, the government has to ask *whether* it can afford it and *how much* money to allot. Deciding how to set priorities among competing interests is a dilemma.

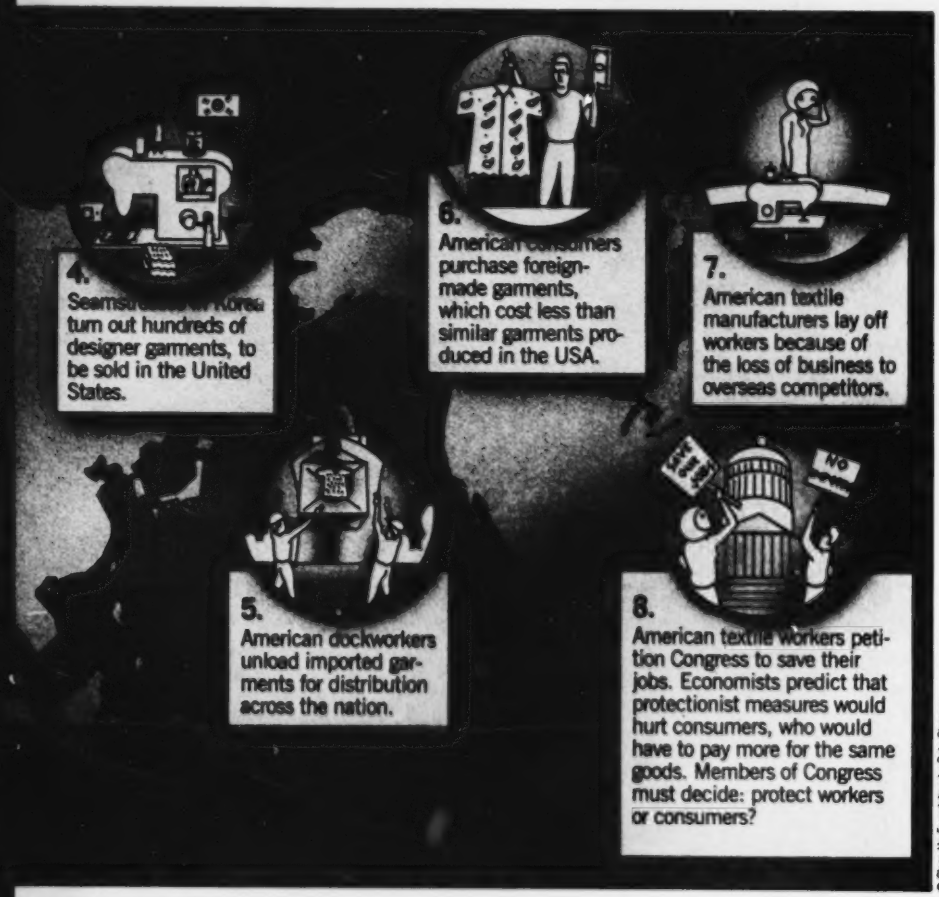
Second, economic decisions are based on predictions about how the economy will respond to different government actions. The practice of economics is a science, involving the analysis of statistics and trends. But economics is also an art. Different economists analyzing the same numbers often produce vastly different results. While economists might be able to predict changes in the economy, they cannot predict human behavior. It is people—business leaders, labor organizers, government policymakers, and consumers—who make the thousands of decisions that shape the world economy every day.

Third, in our system of government, economic decisions are political. America's economic policies are based on more than economic science. Our nation's policymakers must take into account the differing

1.
American fashion designer orders custom-made Italian fabric for new product line.
2.
Italian textile manufacturers hire more workers and enjoy increased profits.
3.
Italian dockworkers ship fabric to Korea.
A Shirt Tale
How Your Economic Choices Affect the Global Economy

social and political agendas of private industry, labor, special interest groups, the president, other members of Congress, and constituents. These and other groups fight to protect their self-interest. They develop elaborate strategies to influence economic decisions at all levels of government.

This book will help you understand why government is involved in the economy, the underlying social values that government tries to promote, and how U.S. economic decisions affect the global economy. The book will give you the background you need to form your own opinions about the role of government in the economy and how decisions made today will affect tomorrow's citizens.


4.
turn out hundreds of designer garments, to be sold in the United States.
6.
purchase foreign-made garments, which cost less than similar garments produced in the USA.
7.
American textile manufacturers lay off workers because of the loss of business to overseas competitors.
5.
American dockworkers unload imported garments for distribution across the nation.
8.
American textile workers petition Congress to save their jobs. Economists predict that protectionist measures would hurt consumers, who would have to pay more for the same goods. Members of Congress must decide: protect workers or consumers?
© Close Up Foundation by Dale Gaugher

1 Government's Role in the Economy

Our national debt after all is an internal debt owed not only *by* the nation but *to* the nation. If our children have to pay interest on it they will pay that interest to *themselves*.

President Franklin Delano Roosevelt

The United States is a country rich in resources. It has an economy that produces great amounts of wealth, especially compared to other countries. Yet even in America, there are not enough resources for everyone to have everything he or she wants or needs. The government tries to control the economy so that most citizens are able to achieve a decent standard of living.

Like the United States, every nation tries to achieve basic economic goals, such as stability and growth. All nations try to balance three basic economic problems—unemployment, inflation, and productivity. Different governments view these problems differently and therefore take different approaches to solving them. This chapter examines the reasons why governments get involved in the economy and the different values they attach to solving them. It also traces the involvement of the U.S. government in our economy and how our view of government's responsibility to the economic well-being of the American people has changed.

Why Governments Get Involved

Governments exist to provide a stable framework within which individuals can operate. Without government, we would have no restrictions on our personal freedom. Neither, however, would our neighbors. With unrestrained individual interests colliding, we might face the situation that philosopher Thomas Hobbes called "the war of all against all." People have historically been willing to accept government rules and policies to avoid chaos.

The reasons why governments are involved in the economy of a nation are much the same. There are many competing interests in the marketplace and many kinds of *resources* to manage. No nation has all the resources it needs or wants. This situation, called *scarcity*, creates the need for economic choices to be made.

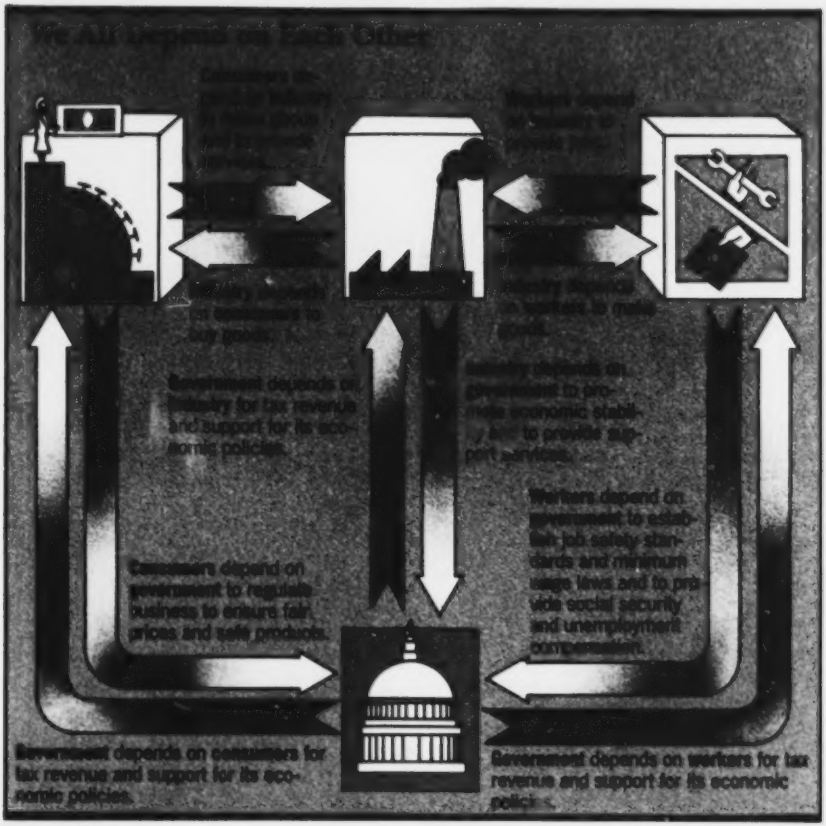

We All Depend on Each Other
Government depends on industry for tax revenue and support for its economic policies.
Consumers depend on government to regulate business to ensure fair prices and safe products.
Workers depend on government to establish job safety standards and minimum wage laws and to provide social security and unemployment compensation.
Government depends on consumers for tax revenue and support for its economic policies.
Government depends on workers for tax revenue and support for its economic policies.

FIGURE 1.1

Every nation must find ways to collect, manage, and distribute its resources to meet the needs and wants of its citizens. Governments take on a leadership role because they are the only institution that has the authority to focus on the needs of society as a whole. Only governments have the power to establish the rules that ultimately will provide for the common good. Without the organized leadership that governments provide, economies would be very inefficient.

In the United States, every actor in the economy is tied to every other actor (figure 1.1). Consumers need industry to produce goods and services. Industries need consumers to buy their products. Government acts as a kind of coordinator for both consumers and industry. Government provides the basic framework in which economic activity takes place.

In the United States, consumers have a multitude of goods and services from which to choose because business is free to sell almost anything that will make a profit. In the Soviet Union, consumers do not enjoy the same variety of goods because the government controls the type and amount of goods produced.

The Goals of Government Economic Action

At the heart of every government's involvement in the economy is a desire to ensure that all citizens have a decent standard of living. In developing nations, this means giving everyone access to food, shelter, medical care, and job skills. In industrialized nations, governments try to improve the standard of living by encouraging economic growth. Economic growth promotes political stability within a nation. It also gives a nation the resources to pursue broader political goals. These might include maintaining a strong national defense, providing a wide variety of social services, and supporting scientific research programs.

All governments establish economic goals for their nations (figure 1.2). Which goals a nation decides to pursue reflects the nation's social and political values. For example, communist nations such as the Soviet Union place a high value on

FIGURE 1.2 ***An ideal economy would balance six basic goals. However, such a balance is difficult to achieve, and some goals — such as economic equity — can only be reached at the expense of another — such as economic freedom. Which goals a government decides to emphasize reflect the nation's social and political values. A government's economic goals change over time, based on the views of the people in power and current economic conditions.***

economic equity and a low value on economic freedom. Democratic-socialist nations such as Great Britain or France place a high value on economic efficiency and a lower value on economic growth. Our nation places a high value on economic freedom and growth and a lower value on economic equity.

How a nation goes about achieving its economic goals is one of the key differences among political systems (figure 1.3). In a communist nation such as the Soviet Union, the government owns most of the resources and makes most of the decisions about how to use and distribute them. The government decides what goods will be produced and in what quantity, sets workers' wages,

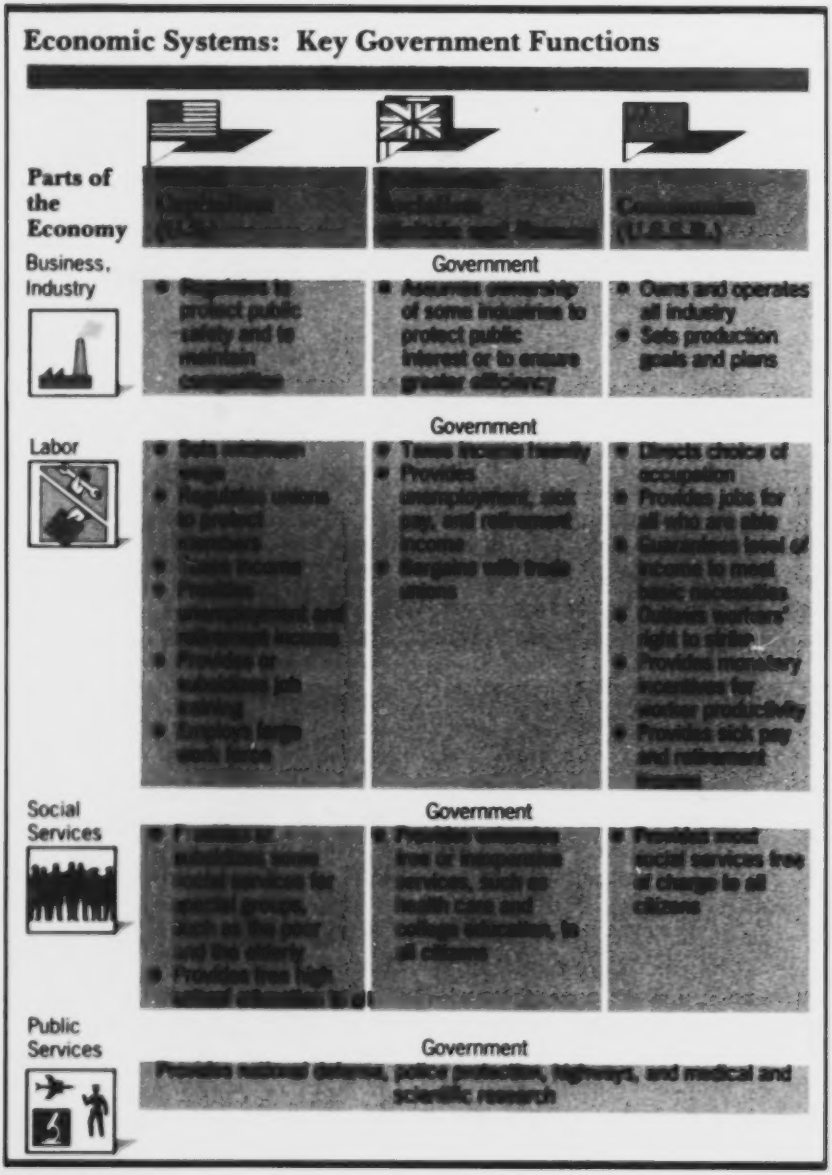

Economic Systems: Key Government Functions
Parts of the Economy
Business, Industry
Government
Labor
Government
Social Services
Government
Public Services
Government

FIGURE 1.3

and guarantees that everyone will have a job. In a mixed-capitalist economy such as ours, the government does not own or operate industries. The government allows individual companies to decide what products they wish to produce, in what quantities, and at what price. The government allows individual citizens to decide where they want to work, in what capacity, and at what level of pay.

As a corollary, production in the Soviet Union is limited to goods that benefit society, because basic needs for food and industrial goods still exist. As a result, consumer goods are scarce in communist societies. You will find no pet rocks or invisible dogs in Soviet stores, while in this country almost anything that may make a profit can be produced.

Contrasting the economic systems of the United States and the Soviet Union suggests that a belief in *competition* is important to us, while *cooperation* is more important in the Soviet Union. In the Soviet Union, individuals work for the good of the community (the State); in this country, individuals work in pursuit of their own goals.

In addition, both the United States and the Soviet Union claim to place a high value on equality, but the concept is very different from one country to the other. Equality of *opportunity*—the idea that anyone can go from "rags to riches" if he or she is clever and industrious—is deeply rooted in American culture. In the Soviet Union, equal *distribution of wealth* is fundamental to the communist philosophy.

Culver Pictures, Inc.

In 1776, Scottish philosopher Adam Smith wrote* Inquiry into the Nature and Causes of the Wealth of Nations. *Smith's theories laid the groundwork for our capitalist system. Smith believed that government should play a limited role in a nation's economy.

In reality, neither country has realized its ideal of equality. Soviet workers have a guaranteed base level of income, but overall pay and standard of living varies, depending on their jobs and where they live. In the United States, everyone has an opportunity—at least in theory—to improve his or her economic status. Yet there are still many barriers—such as education—that prevent people from achieving their economic goals.

It is important to remember that no nation—communist or capitalist—has a "pure" economy. Ele-

ments of free enterprise exist in the Soviet Union, and the U.S. government has sometimes taken control of an industry, such as defense during World War II. And some nations—such as Great Britain and France—have tried to combine elements from both economic systems. This new system—called Democratic Socialism—provides extensive social services for citizens (such as health care and unemployment insurance) and assumes ownership of some industries.

The methods a government uses to achieve its economic goals often change over time. In this country, the government's involvement in the economy has been very different at different stages of our economic development.

The Changing Role of Government in the U.S. Economy

Since the founding of our nation, the U.S. government has gradually expanded its involvement in the national economy (figure 1.4). During the nineteenth century, America changed from an agricultural nation to a major industrial power. Before the Civil War, government actions were largely limited to supporting economic development. For example, Congress fostered competition by passing patent and copyright laws, which protected the ownership rights of people who invented a new manufacturing process or product. The government also gave land grants that promoted settlement of new territories; helped finance construction of highways, railroads, and canals; and instituted tariffs to give new U.S. industries equal advantages in competing with foreign-produced goods.

Government rarely put restrictions on business and industry. It adopted a *laissez-faire* position toward the economy. This concept, supported by economist Adam Smith, is a French term meaning "leave it alone." Rather than trying to manage the economy, the government allowed the marketplace to determine the economic course of

In the late 1800s, industrialists such as John D. Rockefeller formed huge corporations known as "trusts." Through Standard Oil of New Jersey, Rockefeller accumulated a personal fortune of more than $1 billion. In 1911, the Supreme Court ruled that his corporation was a "monopoly in restraint of trade" and therefore illegal according to the Sherman Antitrust Act.

the nation. It allowed consumer *demand* to shape production goals and prices. It allowed the motivation of individual self-interest to fuel industrial invention and growing productivity.

The Beginnings of Government Intervention

By the second half of the nineteenth century, however, unrestricted freedom for business had a variety of destructive consequences. Wealthy industrialists bought competing companies and were able to control entire industries such as oil and steel. Irresponsible management in industries vital to the rest of the nation—such as banking and railroads—caused businesses to fail. Many workers were poorly paid and forced to work in unsafe conditions. Because these decisions made by individual business owners had such a negative impact on the rest of soci-

Milestones in U.S. Economic History 1929-87

1930 | 1935 | 1940

1929 The stock market crashes, leading to the Great Depression.

1930 Congress passes the Smoot-Hawley Act, raising tariffs on imported goods.

1933 President Franklin D. Roosevelt introduces the New Deal to combat the effects of the Great Depression. The role of the federal government in the economy is greatly expanded.

1935 Social Security is introduced.

1935 The National Labor Relations Act is passed to protect the right of workers to organize unions and to engage in collective bargaining.

1935 The Congress of Industrial Organizations (CIO) is formed. The CIO organizes workers in mass production industries, such as steel and automaking.

1938 Congress passes the Fair Labor Standards Act, which establishes a minimum wage and overtime pay and regulates the employment of children under the age of 16.

1941 During World War II, the federal government assumes special economic powers, including rationing goods, setting production goals for the defense industry, and establishing wage and price controls. Women in record numbers enter the work force.

FIGURE 1.4

ety, the government began setting ground rules for the proper conduct of business.

During this period, Congress passed several major pieces of legislation designed to regulate commerce, increase competition, and improve working conditions. In 1887, Congress passed the Interstate Commerce Act, which forced railroads to standardize their shipping rates and prohibited kickbacks to favored customers. The act also established the first federal regulatory agency, the Interstate Commerce Commission (ICC), to administer the new legislation. In 1890, Congress passed the Sherman Antitrust Act, which prohibited the formation of *monopolies*. The act gave small companies the freedom to compete without the fear of being bought out by large conglomerates. Congress also passed a series of acts designed to protect consumers and improve

1945 1950 1955

1944 The Bretton Woods Agreement, with the United States in the leading role, creates the International Monetary Fund and restructures the international financial system.

1955 The American Federation of Labor (AFL) and the Congress of Industrial Organizations (CIO) merge.

1947 Congress passes the Taft-Hartley Act, allowing the government to regulate unions.

1946 Postwar business booms. The United States becomes the world's major economic power.

working conditions. The Pure Food and Drug Act of 1906 required companies to label the contents of foods and medicines. The Workingmen's Compensation Act of 1916 provided assistance to disabled federal employees. The Adamson Act of 1916 established an 8-hour workday for railroad workers. These and other pieces of legislation helped to promote a period of economic growth and prosperity that lasted into the 1920s.

The Great Depression

The year 1929 marked the beginning of an economic disaster. With the collapse of the stock market on October 29, the nation plunged into the Great Depression. Thousands of businesses were ruined, and millions of people were left unemployed. In the cycle of business, it is normal to have periods of growth—with increased production and sales as well as high employment—fol-

Milestones in U.S. Economic History 1929-87, continued

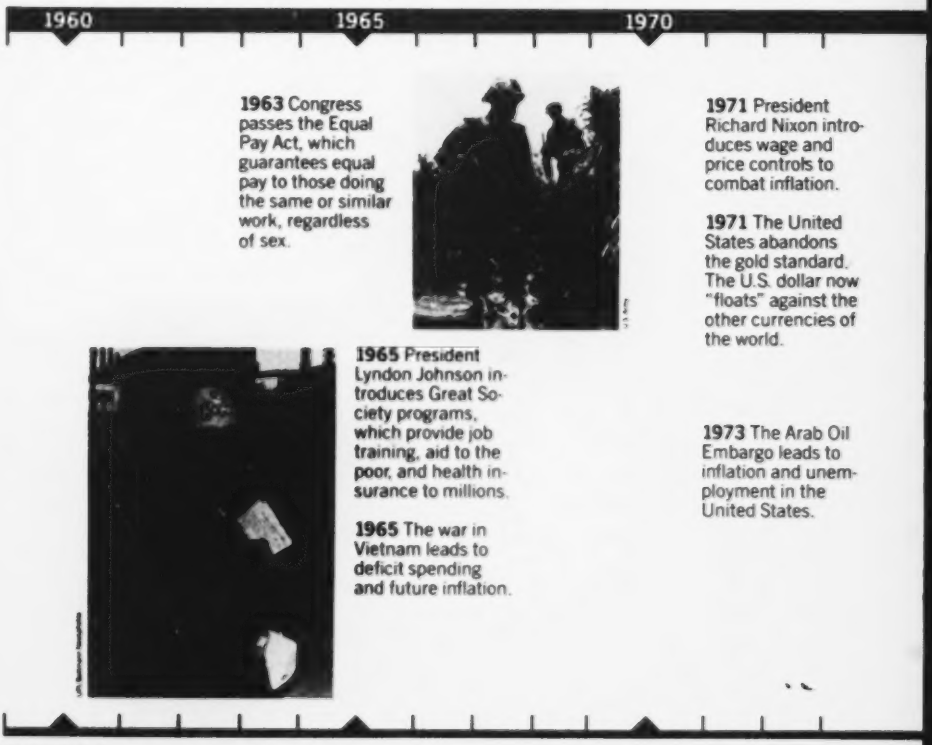
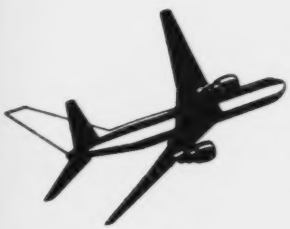

1960
1965
1970
1963 Congress passes the Equal Pay Act, which guarantees equal pay to those doing the same or similar work, regardless of sex.
1971 President Richard Nixon introduces wage and price controls to combat inflation.
1971 The United States abandons the gold standard. The U.S. dollar now "floats" against the other currencies of the world.
1965 President Lyndon Johnson introduces Great Society programs, which provide job training, aid to the poor, and health insurance to millions.
1965 The war in Vietnam leads to deficit spending and future inflation.
1973 The Arab Oil Embargo leads to inflation and unemployment in the United States.

FIGURE 1.4

lowed by slower periods. However, if these fluctuations are extreme, they can threaten the economic stability of a nation. The Great Depression posed such a threat to this nation.

In 1932, Franklin D. Roosevelt was elected president based on his promise of a "New Deal" for all Americans. He used the principles of economist John Maynard Keynes to bring the country out of the depression. Roosevelt spent large sums of government money, much of it borrowed, to put people back to work. Many workers were paid by the government for "public works" jobs, such as repairing roads and building bridges. People with money in their pockets revitalized industry by demanding more goods and services. Government seemed to be the only economic actor that could spend the money needed to stimulate new growth; businesses and consumers did not have the reserves. In theory, when the econ-

1975 1980 1985



1978 Government begins to end economic regulation of the airline, banking, natural gas, and telecommunications industries in order to encourage competition.

1981 President Ronald Reagan institutes "supply-side" economics. Congress passes tax cuts for businesses and citizens to encourage investment, raise productivity, and increase consumer spending.

1981 The national debt reaches $1 trillion.

1986 Congress passes a major tax reform bill.

1987 President Reagan introduces the first trillion-dollar budget.

UPI/Bettmann Newsphotos

The year 1929 marked the beginning of the Great Depression. With nearly one-third of the nation's workforce unemployed, millions of people faced poverty and hunger.

UPI/Bettmann Newsphotos

Elected in 1932, President Franklin D. Roosevelt brought hope to a desperate nation. Roosevelt believed that the government had a special obligation to help the poor, the unemployed, and the elderly. Through the "New Deal," Roosevelt created jobs, guaranteed savings deposits, and established the social security system.

omy recovered, increased revenues from taxes would cancel out the borrowed debt. In reality, it was the industrial growth brought on by World War II that ended the Great Depression.

What Is Unemployment?

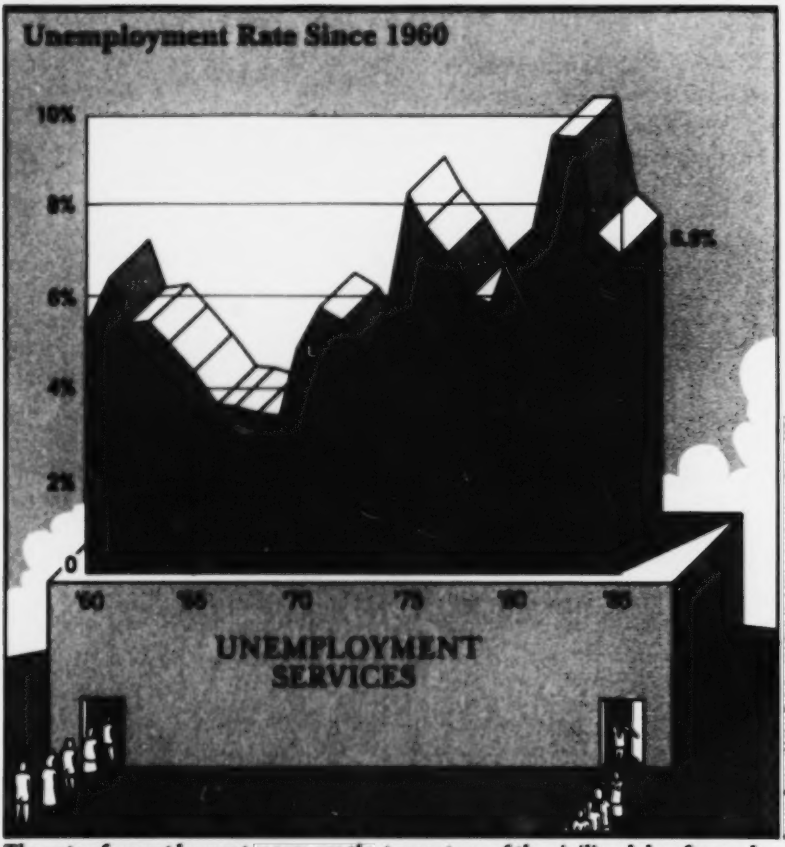
Unemployment refers to the number of people who want to work, but cannot find jobs. Because there are always people between jobs, the unemployment rate is never zero. According to many economists, the economy has *full* employment when only 4 percent of the population is looking for work. However, unemployment figures can be misleading because they do not include people who have given up looking for work.

There are four major types of unemployment.

- *Frictional*—unemployment that occurs when people are between jobs or entering the job market for the first time.
- *Seasonal*—unemployment that results from weather-related changes in demand for certain products.
- *Cyclical*—unemployment that occurs because of downturns in the economy.
- *Structural*—unemployment that results from changes in the economy, making the skills of certain workers obsolete.

The Post–World War II Era

After World War II, the government continued to play an active role in maintaining the economic health of the United States. Businesses saw government intervention in the economy as a way to ensure growth. Citizens looked to the government to ensure economic security through job programs and social security. Presidents Harry S Truman and Dwight D. Eisenhower continued to fund New Deal programs, and federal budget deficits became commonplace.



The rate of unemployment measures the percentage of the civilian labor force who want to work, but cannot find jobs. Many economists believe that the economy is at "full employment" when unemployment reaches 4 percent because some people are always moving from one job to another.

In the 1960s, economic equity became a major government goal. President Lyndon B. Johnson declared a "war on poverty" and proposed a number of government-funded programs that would create, in Johnson's words, a "Great Society." These programs were designed to reduce poverty, provide job training, and guarantee basic necessities such as food and medical care. However, the cost of these programs, coupled with an increase in expenditures for the Vietnam War, produced massive budget deficits, high inflation, and a sluggish economy.

National Archives, Nixon Project

In 1971, President Richard Nixon froze wages and prices for ninety days. This dramatic action was intended to curb spiraling inflation.

When Richard Nixon was elected president in 1968, he vowed to bring inflation down and stimulate economic growth. Nixon cut government spending and in 1971, froze all wages and prices for ninety days. The president hoped that this drastic action would reduce high inflation and revitalize the economy. However, the 1973 Arab Oil Embargo further increased inflation. Long dependent on cheap sources of energy, industries passed their increased energy costs onto consumers. As a result, the price of all goods and services rose even more. High inflation, high rates of unemployment, and slow growth continued to plague the economy through the end of the decade.

What Is Inflation?

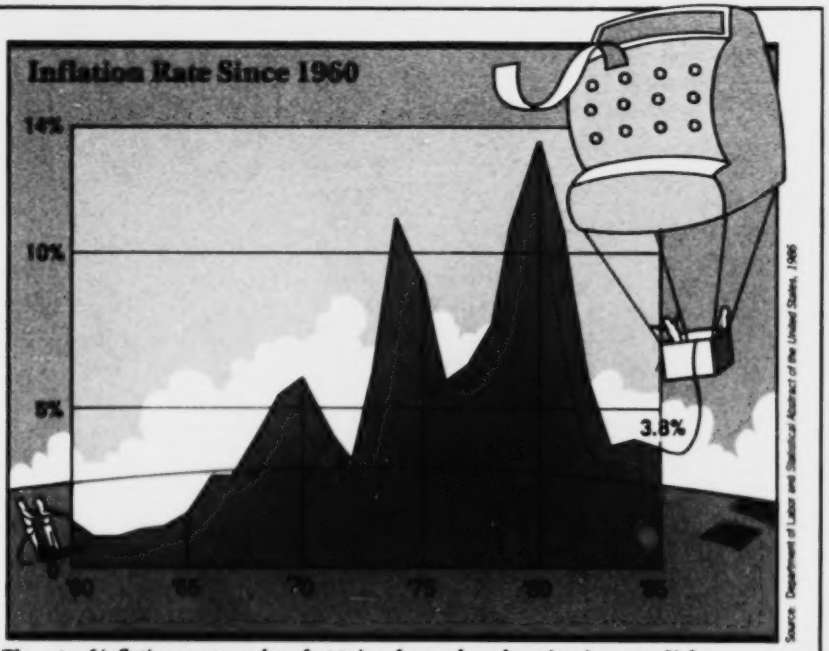
Simply stated, inflation is a continuing rise in prices for goods and services. The higher the rate of inflation, the faster prices rise. In real terms, inflation means that a dollar buys less than it used to. From 1900 to 1982, the *purchasing power* of the U.S. dollar declined from $1.00 to 9¢.

Inflation has many interrelated causes. When the economy is growing, with lots of goods and services produced, most of the population is employed and businesses are doing well. Both businesses and consumers have money to spend, and they are able to purchase all the goods produced. Eventually, there are more people who want to buy than there are goods to go around. Prices go up, because consumers and businesses are willing and able to pay more to get what they want or need.

Inflation can also happen when there is no increase in demand for goods. When the cost of producing goods goes up,

"Reaganomics"

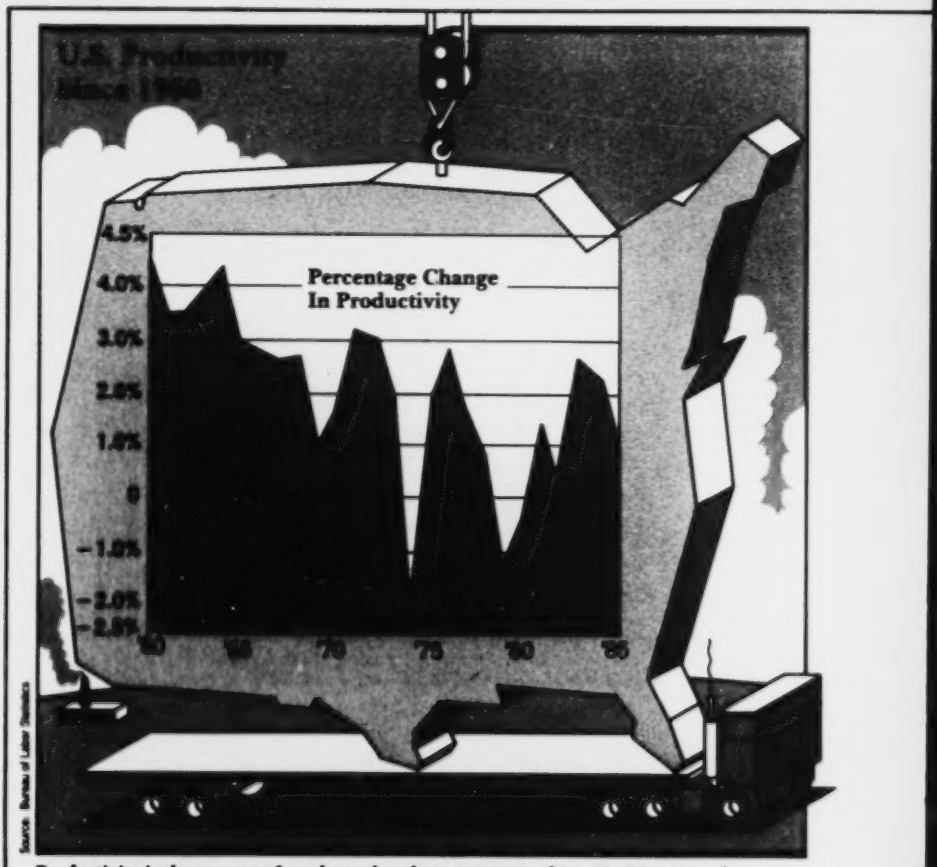
When Ronald Reagan was elected president in 1981, he brought a new economic philosophy to the White House. Traditionally, the Keynesian idea—that government spending would stimulate a sagging economy—had guided previous presidents in developing economic policy. Yet the growth of government services since the 1930s had forced the government to borrow more money—much more—every year than it collected through taxes and other revenue.



The rate of inflation measures how fast prices for goods and services increase. Unless accompanied by a comparable rise in wages, inflation lowers a person's standard of living.

businesses increase the prices consumers have to pay. For example, when the price of oil went up in 1973, so did the price of all petroleum-based products, such as record albums, plastics, and synthetic fibers (e.g., polyester). Another reason it may cost businesses more to produce the same goods is if employees or unions negotiate for large wage increases. The cost of wage increases is usually passed on to the consumer in the form of higher prices.

Ronald Reagan's economic policy, called *supply-side economics*, was based on a belief that government's role in the economy should be limited. Reagan promised to "get the government off the backs of the people" by decreasing federal government spending on social programs and decreasing government regulation of business and industry. He felt that businesses and consumers should be allowed to pursue their own interests within a free marketplace, not controlled by the federal government. Reagan's long-term goal was to create a healthy



Productivity is the amount of goods produced per person per hour. A rising rate of productivity usually leads to higher wages, higher profits, and lower prices. Historically, newer and more efficient machinery has enabled industry to produce more with the same amount of effort.

economic environment by giving individuals and businesses an incentive to produce more.

Reagan felt that the best incentive was to give business and consumers more money by cutting taxes. He asked Congress to pass the highest tax cut in history. After all, why work harder if the money you earn is eaten up by high taxes? He also believed that high business taxes hurt productivity. If the nation's productivity were to increase, he reasoned, economic growth would occur without inflation. In turn, economic growth would increase tax revenues, and the budget deficit would be reduced.

Although inflation did decrease by the early 1980s, tax revenues declined sharply after the tax cut. Government spending continued to increase, especially for national defense, and the budget deficit grew. Today, the government spends almost $200 billion more than it collects in revenues. The budget deficit poses a major problem for the future. Are the American people willing to sacrifice government spending for social programs and the nation's defense for a balanced budget?

President Ronald Reagan's economic policies were based on "supply-side" theory. He believed that cuts in government spending and taxes would decrease inflation and bring about long-term economic growth.

What Is Productivity?

Productivity is the efficiency with which goods and services are produced, as measured by the quantity produced by each person per hour. A rising rate of productivity usually leads to higher wages, higher profits, and lower prices. Most economists agree that the best way for an industry to increase its productivity is to invest in new, more efficient machinery and technological advances that will enable workers to produce more with the same amount of effort.

Governments use productivity rates as one way of monitoring the economic health of their nations. High productivity can mean high economic growth. Low productivity can mean a sluggish economy—fewer goods being produced at a higher cost. As a result, fewer goods are purchased by consumers, and unemployment increases.

2 How Government Affects the Economy

There's only one place where inflation is made: that's in Washington. The voting public ask their Congressmen to enact goodies in the form of spending, but they are unhappy about having taxes raised to pay for those goodies.

Milton Friedman

The steady, measured growth that gives economic prosperity without inflation or recession is not easy to produce. The federal government has several tools that it can use to influence economic conditions. These tools are powerful, with the potential to affect the key elements of the economy. They can be used to treat a failing economy as well as to prevent unhealthy trends from beginning. Government has assumed this responsibility, because the free market alone has not maintained a desirable balance.

This chapter discusses the three ways in which government influences the economy: *monetary policy*, which establishes the amount of money available in the economy; *fiscal policy*, which determines government spending and taxation; and *trade policy*, which regulates U.S. trade with foreign nations.

Making choices in the use of these policies involves much more than economic "science." Each involves political issues, competing social values, and philosophical questions about the proper role of government in the economy.

Monetary Policy

Money is society's medium of exchange. It is anything generally accepted as payment for goods and services. Every nation needs a consistent flow of money in its economy to allow consumers to buy the goods that keep production levels high. Money is also used by industries to upgrade their factories and invest in future growth.

Our government attempts to influence the amount of money in circulation (*money supply*) to promote stable economic growth in our nation. This function, known as monetary policy, is entrusted to the Federal Reserve System (also called the Fed).

The Federal Reserve System

Founded in 1913, the Federal Reserve System serves as the "banker's bank." All commercial banks are required by law to keep a certain amount of money on deposit with the Fed, which holds that money in reserve. Commercial banks earn interest on their deposits with the Fed and can also borrow from the Fed when their funds run low.

The Fed is the agency charged with carrying out the government's monetary policy by making the decisions about the money supply. When the economy is slow, the Fed *increases* the money supply to make more funds available for business expansion and consumer spending. Increasing the money supply helps stimulate growth in the economy.

When the economy is growing at too fast a pace, with prices rising in an inflationary spiral, the Fed *decreases* the money supply. With fewer dollars available for businesses and consumers, the economy slows down and inflation begins to fall. Later, after inflation is brought under control, the money supply can be expanded again to promote growth, and the cycle begins again.

To carry out the government's monetary policy, the Fed has three tools. It can: (1) change the *reserve requirement* (i.e., the amount of money commercial banks are required to keep on reserve with the Fed); (2) buy and sell *government bonds;* and (3) set *interest rates.*

Changing the Reserve Requirement. To understand how the Fed influences the money supply, it is first necessary to understand how commercial banks are related to the Federal Reserve System. Commercial banks make a profit by taking deposits from people who want to save money and then lending those same dollars to consumers and businesses who want to borrow money. Commercial banks join the Federal Reserve System to protect themselves against concentrated withdrawals of money. If all bank customers were to ask for their money at the same time, the bank would be forced to borrow money from the Federal Reserve. The Federal Reserve provides member banks with as much money as they need to

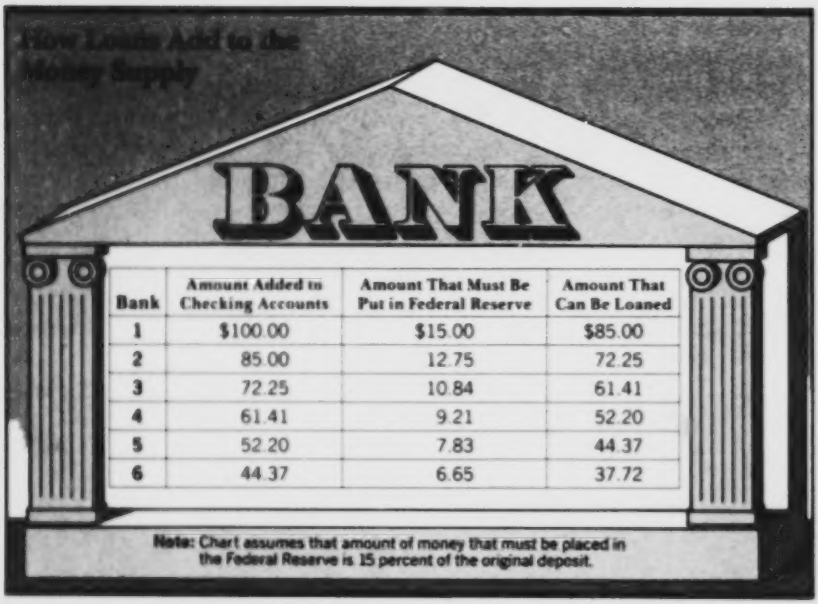
Money is anything generally accepted as payment for goods and services. In the United States, money comes in many forms, but only* legal tender *must, by law, be accepted in payment of a debt. Legal tender is Federal Reserve notes (paper money) and government-issued metal coins.

Paul Volcker, chair of the Federal Reserve Board, has been called the second most powerful man in the nation. Volcker's agency controls the nation's money supply, which affects the spending habits of all Americans—and thus the economic health of the nation.

cover customer loans, deposits, and withdrawals.

However, in order to make this guarantee, the Fed needs its own reserve of money. The Fed acquires its reserve by requiring member banks to transfer a certain percentage of their deposits (called the *reserve requirement*). These funds are held in reserve at one of the Fed's twelve regional banks.

The Fed can affect the money supply by changing the reserve requirement. When commercial


How Loans Add to the Money Supply
BANK
Note: Chart assumes that amount of money that must be placed in the Federal Reserve is 15 percent of the original deposit.

Bank	Amount Added to Checking Accounts	Amount That Must Be Put in Federal Reserve	Amount That Can Be Loaned
1	$100.00	$15.00	$85.00
2	85.00	12.75	72.25
3	72.25	10.84	61.41
4	61.41	9.21	52.20
5	52.20	7.83	44.37
6	44.37	6.65	37.72

FIGURE 2.1 ***When banks lend money to their customers, they actually add to the money supply. For example, when a customer deposits $100 in a checking account, the bank must place a percentage of the money in the Federal Reserve. The bank can then loan the rest of the money to another customer. If this process is continued, until the amount available for loans is zero, the original $100 loan will have added $666.70 to the economy.***

banks lend money to their customers, they actually add to the money supply (figure 2.1). For example, when Bank 1 loans $100.00 to Mr. Jones, Jones deposits it in his bank, Bank 2. Bank 2 has to reserve 15 percent of it in the Federal Reserve, but it loans the other $85 to Ms. Smith. She deposits $85 in her bank, Bank 3. Bank 3 loans the allowable percentage, $72.20, to another borrower. When this process is played out through the tenth bank, the banking system has in effect created $666.70 in deposits from the original $100.00 loan.

If the Fed *raises* the reserve requirement, banks will have less money to loan. Fewer loans mean that fewer cars, homes, and other expensive items are bought, because there is less money for consumers to borrow. In turn, this means that less money is being added to the money supply. If the Fed *lowers* the reserve requirement, banks will have more money to loan. More loans mean more money is available to consumers to buy cars, homes, and other expensive items. More loans also mean that more money is being added to the money supply.

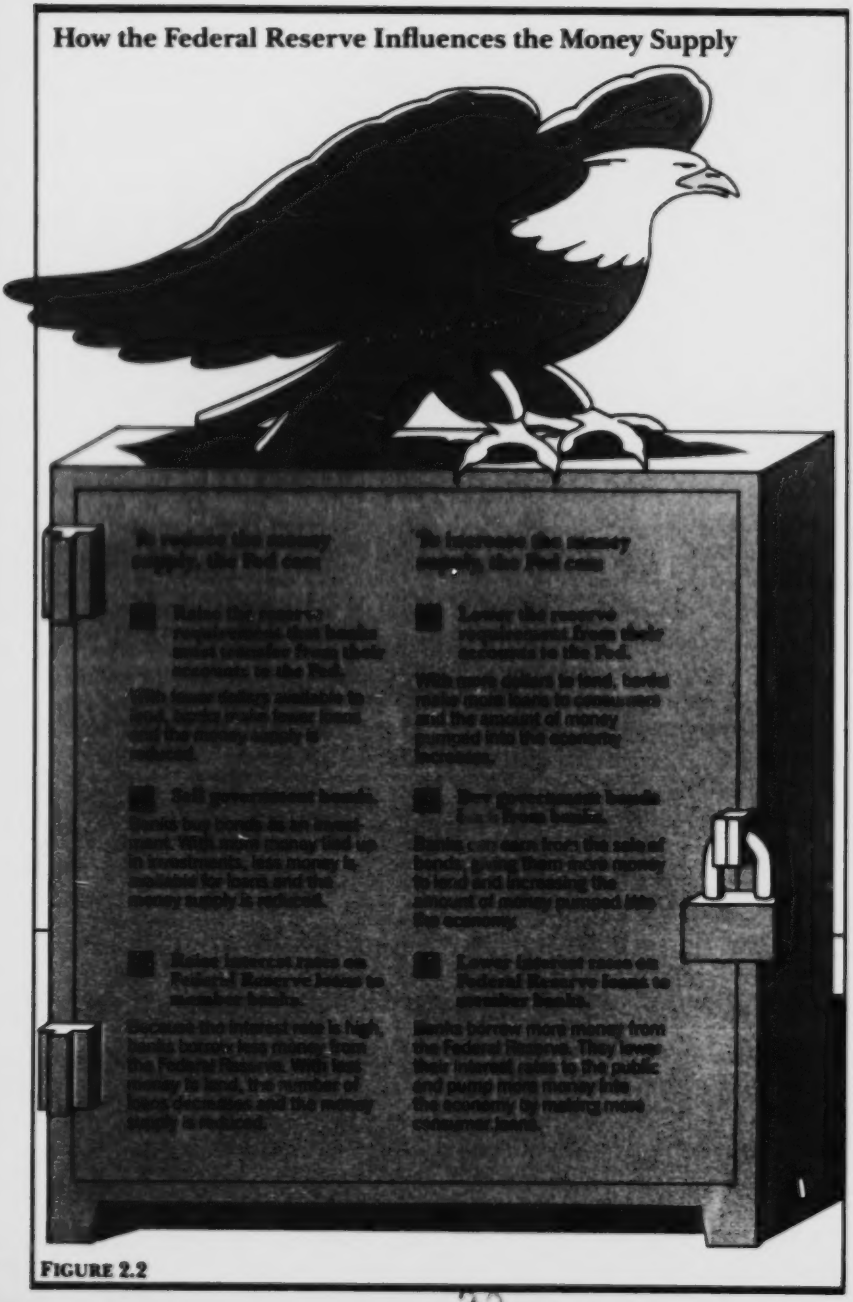


FIGURE 2.2

Buying and Selling Government Bonds. Another way the Fed can influence the money supply is by selling bonds to banks and then buying them back. Bonds are certificates issued by the government, which promise to pay the buyer the face value of the bond plus interest after a certain amount of time. When the Fed *sells* government bonds, banks buy them, leaving a smaller amount of money available for consumer loans. When the Fed *buys* bonds back from banks, the banks have more money to lend. In this way, the Fed can affect the money supply.

Setting Interest Rates. The Fed charges interest on every loan it makes to a member bank. The interest rate the Fed charges is known as the *discount rate*. By *increasing* the discount rate, the Fed can *discourage* commercial banks from borrowing money. Commercial banks will then have less money to loan, and therefore, less money will be pumped into the economy. By *decreasing* the discount rate, the Fed can *encourage* commercial banks to borrow money from the Fed. This injects more money into the economy, because banks have more money to loan.

Which Monetary Policy?

The Fed has tremendous impact on the U.S. economy (figure 2.2). When the Fed *expands* the money supply, it is known as a time of *easy money*. An easy money policy is always popular with consumers because it means they will be able to obtain low-interest loans. The Fed pursues an easy money policy when there is high unemployment or when the economy is sluggish. Easy money boosts production and creates jobs. However, easy money can lead to a rise in inflation and high prices.

When the Fed *contracts* the money supply, it is known as a time of *tight money*. A tight money policy is seldom popular with consumers because it means that consumer loans will be hard to obtain and interest rates will be high. The Fed pursues a tight money policy during periods of high inflation. Tight money slows down the economy and decreases inflation. However, tight money can lower consumer demand for goods, which lowers production, which eventually leads to higher unemployment.

For the most part, the Fed attempts to strike a balance between an easy money policy and a tight money policy. It will favor first one policy, then the other, in an effort to maintain overall economic stability.

Fiscal Policy

One of the most direct ways in which the government affects the economic health of the nation is through fiscal policy. Fiscal policy is the government's plan for collecting income (taxes) and spending money (expenditures). This plan is known as the federal budget. Every year the president initiates the budget

How Uncle Sam Can Meet His Expenses

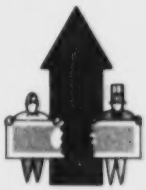
	Advantages	Consequences
Borrow Money	• Government services and programs can continue • Government retains political support from those helped by federal programs • Money is pumped into the economy, which stimulates economic growth	• Interest rates may increase because the amount of money available for loans to businesses and consumers may be reduced • Industries that rely on credit sales, such as housing and autos, suffer because consumers cannot afford to make long-term purchases on credit • National debt increases • Value of the U.S. dollar (in relation to foreign currencies) may increase. Sales of U.S. goods in foreign countries may decline
Increase Taxes 	• Level of government services continues or grows. Government retains political support from those helped by federal spending • Budget deficit may be reduced • Inflation may be brought under control because consumers have less money to spend	• Consumers have less money to spend or invest • Government may lose political support • Economic growth may slow down because consumer demand decreases
Spend Less	• Budget deficit may be reduced • Private sector assumes responsibility for functions previously performed by government • Banks have more money available to lend to consumers and businesses	• Government services may be cut back • Government may be less able to stimulate a slow economy through public spending • Reduced government services may lead to a decline in the standard of living for some members of society

FIGURE 2.3

process by submitting a budget to Congress for approval. From start to finish, the process of developing the federal budget takes about a year and a half.

The federal budget has a tremendous impact on the national economy (figure 2.3). It determines how much revenue the government must collect, and how much money

the government will spend on programs such as national defense, education, transportation, and medical research. The government decides how many B-1 bombers will be built, how much money will be available for student loans, how many air-traffic controllers are hired, and how much money is put into AIDS research. The amount of money that the government decides to spend on these and other programs has a direct effect on jobs, individual spending, and ultimately, the security of the nation.

How Fiscal Policy Affects the Economy

Every year, the government must determine its fiscal policy—that is, how much money it is going to spend and how much tax revenue it will collect. Through fiscal policy, the government identifies national problems that need immediate attention. The government uses these two components to influence the rate of unemployment, control inflation, and regulate the amount of money that is in circulation.

Taxes. The government needs to collect money from citizens to pay for everything from salaries for government workers to the purchase of nuclear weapons. The amount of taxes the government decides it needs to collect in a given year has a profound effect on the economy. The amount of money each person has left after taxes determines how much money an individual will have to spend on goods and services.

When the government *increases* taxes, consumers have *less* money to spend. When consumers have less money to spend, the economy slows down. The government can use an increase in taxes to bring inflation under control.

When the government *decreases* taxes, consumers have *more* money to spend. When consumers have more money to spend, the demand for goods and services increases and jobs are created. Often the government uses a decrease in taxes to fight unemployment and stimulate a sluggish economy.

Spending. Government spending affects millions of people. For example, if the government decides to increase the amount of money it spends on cancer research, the demand for doctors, medical researchers, and chemists will increase. Conversely, if the government decides to cut spending in a particular area, the industries providing those services will be hurt.

When the government *increases* its overall spending for goods and services, more money is pumped into the economy and production and employment levels rise. When the government *decreases* spending, it has the opposite effect.

Which Fiscal Policy?

For many years the government has relied on Keynesian economic theory to guide its fiscal policies. Un-

der Keynesian theory, government borrows money to stimulate a sluggish economy; when the economy recovers, additional tax revenues are supposed to pay off the debt. Since the 1930s, however, government spending has steadily increased, regardless of the health of the economy, and tax revenues have not increased sufficiently to reduce the national debt.

In the early 1980s, the Reagan administration and Congress cut taxes by 25 percent. This rejection of Keynesian principles, known as *supply-side economics*, was intended to allow businesses and consumers to keep more of their earnings, which they would—in theory—spend. An increase in consumer spending would increase production, which would increase jobs and tax reve-

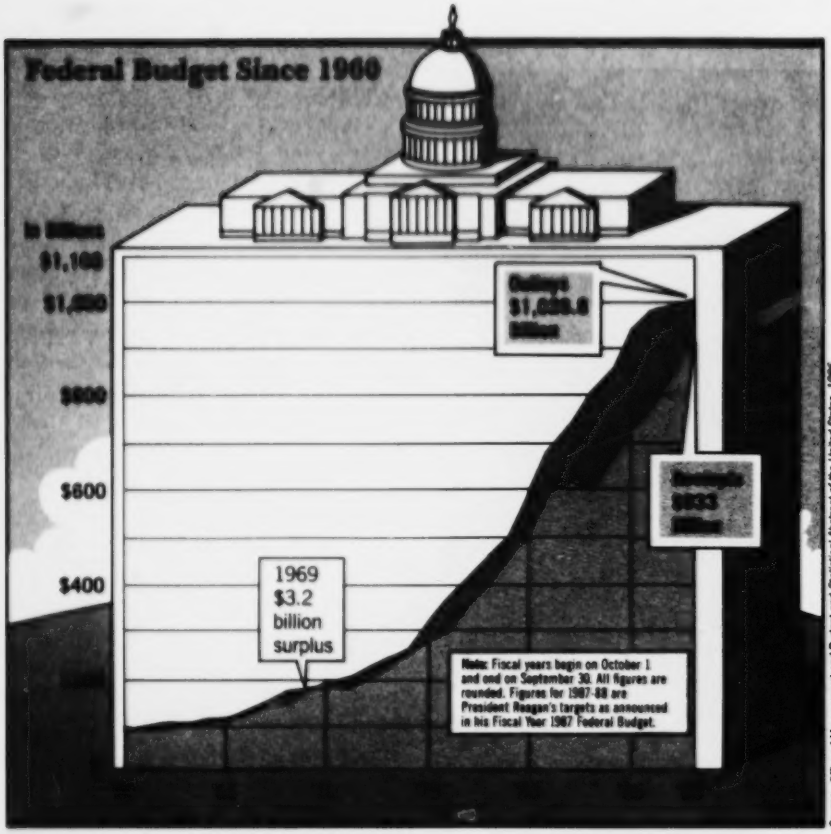
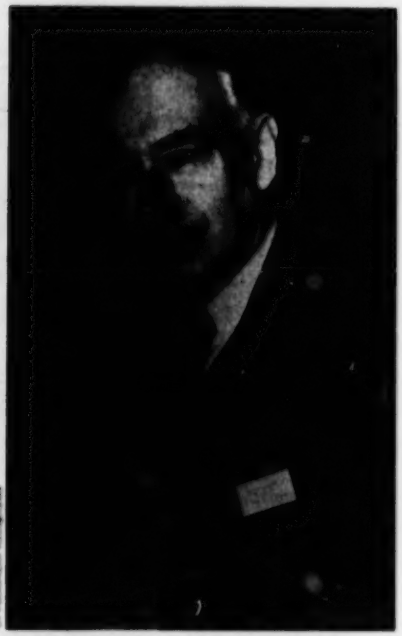

Federal Budget Since 1960
$800
$600
$400
1969
$3.2
billion
surplus
Notes: Fiscal years begin on October 1 and end on September 30. All figures are rounded. Figures for 1987-88 are President Reagan's targets as announced in his Fiscal Year 1987 Federal Budget.
Sources: Office of Management and Budget and Statistical Abstract of the United States, 1986

FIGURE 2.4 ***Since 1960, the federal government has only had one surplus. The national debt is now more than $2 trillion. Policymakers are actively seeking ways to reduce the budget deficit.***

nues. An increase in tax revenues would offset the federal budget deficit. The end result would be a growing economy with no inflation and a balanced federal budget. Unfortunately, the tax cut did not produce the desired results (figure 2.4). The rate of government spending continued to increase, and taxes failed to increase as projected. The gap between spending and revenue widened.



UPI/Bettmann Newsphotos

British economist John Maynard Keynes has shaped U.S. economic policy in the twentieth century. In his book,* The General Theory of Employment, Interest, and Money, *Keynes advocated that government fund job programs and other projects to help ease unemployment and stimulate the nation's economy.

Trade Policy

International trade is essential to the American economy. The United States exports more than $200 billion worth of goods every year, and one out of every eight manufacturing jobs in the United States relates in some way to products sold overseas.

When nations trade, their economies grow faster than they would if all goods and services were produced for just their people. Most countries have a particular *comparative advantage*—such as location, climate, skilled labor, *capital* (money for investment), or technical superiority—that enables them to make certain products at a lower cost than other countries can. Comparative advantage allows every country to profit by trading those goods it produces most efficiently for those products made more efficiently in other countries. In this way, trade increases a country's standard of living.

Government Trade Policy

American business looks to the government to further their interests in the international marketplace. The economic interdependence of the United States and other countries makes our economy vulnerable to the actions of foreign competitors. U.S. trade policy is designed to promote the interests of U.S. industries both at home and abroad.

International trade policy greatly

UPI/Bettmann Newsphotos

Sometimes governments restrict imports to protect a domestic industry. For example, in 1981 the Reagan administration restricted the number of Japanese cars that could be imported into this country to help American car manufacturers recover from lagging sales.

affects the economy of the United States. By promoting the nation's industries, the U.S. government aims to protect American jobs. The goals of U.S. trade policy are to ensure economic growth at home and promote free competition in the world marketplace.

The Tools of Trade Policy

The U.S. government uses several tools to promote American interests in the world market. These include restricting imports, promoting exports, and working cooperatively with other nations to stabilize the international marketplace.

Restricting Imports. Tools that restrict imports are considered trade barriers, or *protectionism.* These include:

- *Tariffs*—taxes imposed on foreign products.
- *Quotas*—limits on the amount of foreign goods that can be imported.

The U.S. government imposes trade barriers to protect "infant" industries. For example, Congress passed the Tariff of 1816 to help protect newly developing American industries. This tariff, which imposed a tax on foreign goods, was

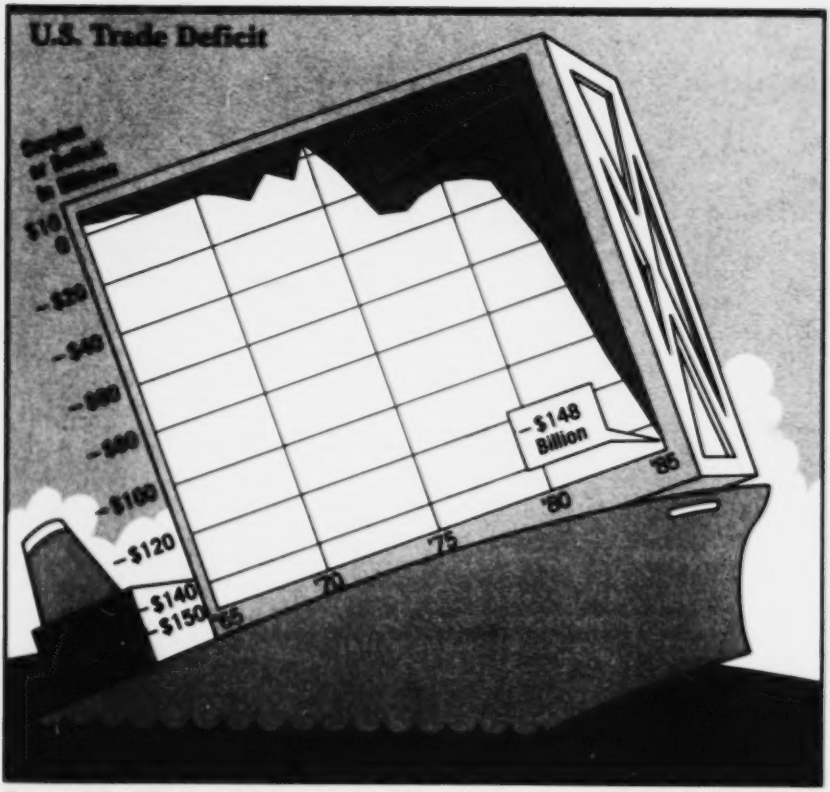


FIGURE 2.5 ***The United States has experienced a growing trade deficit over the past several years. The deficit has meant less profits for U.S. companies and fewer jobs for American workers.***

designed to encourage growth in the American textile industry. As a result of the tariff, domestic goods were less expensive than foreign goods, and therefore, sales of American-made products increased.

The U.S. government imposes trade barriers to help an industry recover from a slow period. For example, in 1981, the United States asked Japan to put quotas on the number of Japanese cars imported into the United States. This action helped U.S. automakers out of their worst economic slump since World War II.

Promoting Exports. The United States can give or loan money to make U.S. products more attractive to overseas buyers. It can:

- provide *low-cost loans* or *foreign aid* to nations that purchase exports from the United States.

- provide *subsidies* to a domestic industry to help it lower production costs.

The United States gives aid to other nations with the understanding that a portion of the money will be spent on American goods. For example, in 1985, the government's Export-Import Bank lent $660 million dollars to nations to stimulate the purchase of American-made products abroad.

To help American farmers compete on the world market, the federal government provides crop subsidies and low-cost loans. The government has even paid some farmers not to grow food in order to keep agricultural prices up.

Working Cooperatively with Other Nations. Since the mid-1930s, the United States has tried to work cooperatively with other nations to reduce trade barriers and to promote an international free market. In 1934, Congress passed the *Reciprocal Trade Agreements Act*, which allowed the United States to establish favorable tariffs with one country in return for the same favored status.

Which Trade Policy?

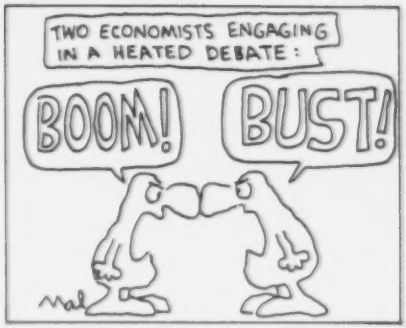
Since the late 1970s, the United States has suffered from a *trade deficit* (figure 2.5). In 1985, the United States had a record trade deficit of $148 billion. This means that the total value of goods that the United States imported was worth $148 billion more than it exported.

Effects of Protectionism
Consumers may have
• higher prices
• fewer goods to choose from
• less money to buy other products
Protected U.S. industry may have
• more jobs
• higher profits
• less incentive to produce goods more efficiently because of decreased foreign competition
Other U.S. industries may have
• foreign trade barriers imposed on them in response to U.S. protectionist policies
• reduced sales overseas because other countries are selling fewer goods in the United States
• lower sales in the United States because consumers have less money to spend
• higher unemployment
Other nations may have
• higher unemployment
• lower economic growth
• ill will toward the United States, which may affect political relations

FIGURE 2.6 ***Protectionist measures, such as tariffs and quotas, can have far-reaching effects. They can increase the amount consumers pay for certain goods, cause other nations to impose tariffs on their own, and strain relations between trading partners.***

To balance the trade deficit, Congress has come under intense pressure to erect trade barriers. This pressure has come from U.S. industries that have been hurt by foreign competition. These industries maintain that they need government intervention to save American jobs and keep their businesses healthy.

At the same time, Congress is also being pressured to keep the avenues of free trade open. Many economists feel that industries that cannot compete in the international market should not be given help. Protectionist policies can backfire and lead to higher prices for domestic products (figure 2.6). Protectionist measures can also cause other nations to erect their own tariffs and quotas in retaliation.



Monetary, Fiscal, and Trade Policies: Powerful but Imperfect Tools

Monetary, fiscal, and trade policy decisions each involve complex factors. Trying to balance and control their *combined* effect on the economy is very difficult for three reasons.

First, decisionmakers have no clear-cut rules for applying the government's economic tools. The United States has only had about fifty years of experience in using them to regulate the economy, and many changes have occurred in the U.S. economy during this time. To date, there are no guaranteed formulas for combining policy options to produce desired results.

In addition, the government and business groups keep extensive statistics on the economy, which they use to help predict future trends. Yet economic experts differ over how to use these indicators and which ones are most important. They only agree that each measurement tool has flaws that limit its success as a crystal ball. Thus, much of government's decisionmaking is a trial-and-error process.

Second, the government's economic policy is not one uniform decision. It is the combination of many individual decisions made by many different agencies. These decisions are not always coordinated. For example, in the early 1980s, the Federal Reserve tightened the money supply to slow economic growth. At the same time, Congress cut taxes in an effort to stimulate the economy. Thus, government policymakers sometimes work

against each other in trying to achieve economic goals.

Third, government actions are only one element of the economic equation in a free economy. Businesses and consumers can take independent actions that contradict the effects of government policies. For example, government can use monetary controls to raise interest rates with a goal of cutting rising inflation. Yet unions may have long-term contracts that guarantee automatic salary increases—which are inflationary. In addition, businesses may look at the rise of inflation and (1) anticipate that the government will tighten the money supply, then (2) borrow money immediately, before interest rates go up. These and other actions can thwart government's plans to control inflation.

3 American Values and Economic Policy

American values—equality of opportunity, a decent standard of living, and the security of our nation—lie at the heart of all government policies. The U.S. government raises revenue, funds programs, and passes laws to create the kind of society Americans want to live in. Given enough resources, our government could fulfill all our desires. But limited funds force the government to make choices. Every policy decision must reflect more than America's vision of what our nation should be. Every political decision must also take into account its economic consequences.

What kind of action should government take to support the nation's values? In most cases, the programs that government chooses reflect policymakers' beliefs about the proper role of government in the economy. Many countries share our values. But the approaches that the U.S. government uses to pursue these values are uniquely American.

Defining American Values

The United States has long been called the "land of opportunity." For those who want to improve the quality of their life, America provides them with the chance to do so. It is a primary reason why settlers came here three centuries ago. And it is a primary reason why people come to our country today.

To ensure that equal opportunity is maintained, the government has instituted programs over the years that reduce barriers against discriminatory practices and provide the means for economic advancement to people and businesses. For example, the government has passed legislation barring discrimination against women, minorities, and the handicapped and has mandated equal pay for equal work. It also provides low-cost loans to students wishing to go to college and to entrepreneurs wishing to start their own businesses.

Our free-enterprise system can reward individual initiative with great wealth. However, our society does not want a system that punishes lack of economic success with hunger, lack of shelter, or inadequate clothing. We recognize that, at some point in their lives, some people need help.

To help all citizens maintain a de-

Unsplash/Rob Diamond

America is one of the wealthiest nations in the world. As a society, we believe in freedom, opportunity, and justice. Our elected officials develop policies that support our values.

cent standard of living throughout their lives, the government takes action to help all Americans obtain the necessities of life and reduce poverty. For example, the government provides food stamps, public housing, public health care programs, and social security. It also provides preschool education for underprivileged children and job-training programs for the unemployed.

The U.S. Constitution charges the federal government with the responsibility of "providing for the common defense," or the nation's security. In the past, the government kept America safe by maintaining friendly relations with neighboring nations. Today, however, modern weapon technology makes this strategy obsolete. Unfriendly nations from around the world now have the capability to attack the United States within a matter of minutes.

In the modern world, the government ensures the security of our nation through a variety of means. The government promotes friendly diplomatic relations with other nations, negotiates mutual defense treaties with allies, and maintains military forces—both nuclear and conventional—at home and around the world.

Government decisions on these and other issues are a complex interplay of social, economic, and political values (figure 3.1). In our system of government, decisionmaking involves more than analyzing the

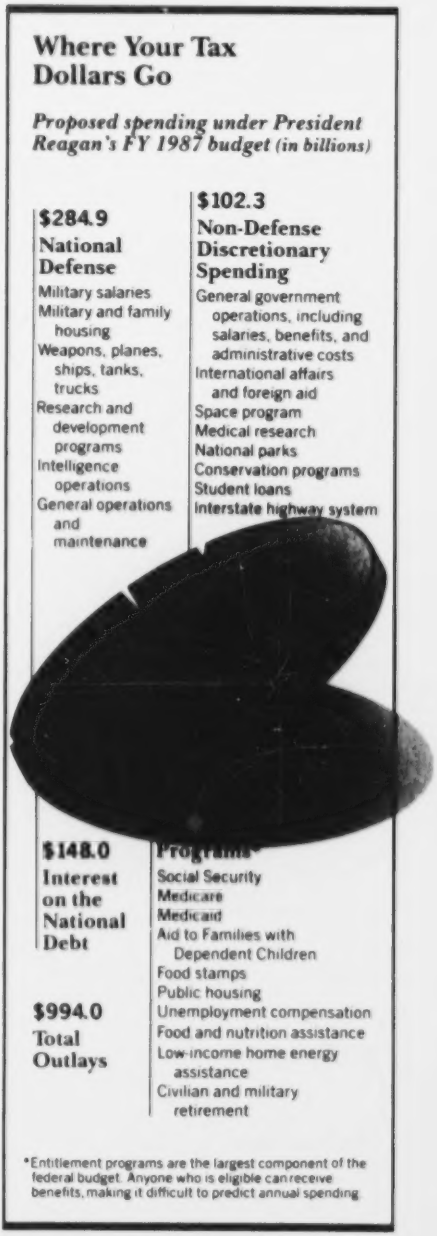


FIGURE 3.1

How Immigration Reform Affects the Economy

Some economists predict that the Immigration Reform and Control Act of 1986 could have the following effects.

- Former illegal aliens will be able to join unions and compete for better-paying jobs. The United States loses a work force that has been willing to work for low wages in unattractive jobs.
- Industries that rely heavily on poorly paid illegal aliens, such as agriculture or textiles, may have to raise prices. Some businesses may have to mechanize or move to other countries where labor is relatively cheap.
- Former illegal aliens could strain local government resources. Millions of people will become eligible for public education, public housing, public assistance programs, health care benefits, and police and fire protection.
- Higher unemployment among Hispanics and other ethnic groups could result. Employers may hire "Anglo-looking" employees to avoid violating the new law.

Artwork courtesy of U.S. Dept. of Justice, Immigration and Naturalization Service

FIGURE 3.2

facts and selecting the most sensible option. Decisionmakers must balance social values and economic realities. The question that decisionmakers face today is not only whether we as a nation want or desire a particular program, but also whether we can afford it.

The Conflict Between Social Values and Economics

Sometimes the link between social values and economics is straightforward, such as when Congress decides how much money to give a particular social welfare program. Other times, the economic ramifications of passing a new law are less obvious, such as when Congress passed the Immigration Reform and Control Act of 1986, which made millions of illegal aliens eligible for citizenship (figure 3.2). Analysts predict that the economic consequences of this law will be far-reaching. For example, many of the industries where illegal aliens worked will not be competitive if they are forced to pay higher wages.

Congress is the political arena in which the nation's economic policies are made. The making of the federal budget is a showcase for the conflict between what Americans want and what we can afford.

The Making of the Federal Budget

The executive branch and Congress share responsibility for the budget. Although the president ultimately approves the federal budget, the national debate concerning actual spending levels goes on for months in advance (figure 3.3). At every point in the decisionmaking process, different interests compete with one another, each one attempting to influence the final outcome.

The major players in the federal budget process are the president, federal agencies, interest groups, and the public. Ultimately, it is the decisions of 535 members of Congress that determine the nation's spending priorities.

The President. The president delegates the responsibility of drawing up the federal budget to the Office of Management and Budget (OMB). The director of OMB reports directly to the president. The president relies on the director to track government spending and revenues and to establish a budget based on the priorities of the administration. By law, the president is required to submit a budget for the upcoming year to Congress for approval every January.

Presidents can be very effective lobbyists on behalf of their spending priorities. They have a tremendous amount of power at their disposal. A simple phone call from the president to a member of Congress can influence the way that member

The White House

James C. Miller III, director of the Office of Management and Budget (OMB), develops President Reagan's yearly budget proposal. Miller is responsible for translating the president's political agenda into fiscal policy.

votes. Presidents can also use more subtle means to influence votes, such as inviting members of Congress to Cabinet meetings, private meetings with the president, and special White House dinners. As one former member of Congress said, "When the attention of the most important person in the free world is focused on you, even for a short while, it can weaken one's defenses."

Federal Agencies. Every federal agency fights hard to retain or add to its share of budget dollars. Every agency makes a strong case to both the OMB and Congress to prove that its programs are effective, well run, and necessary. For example,

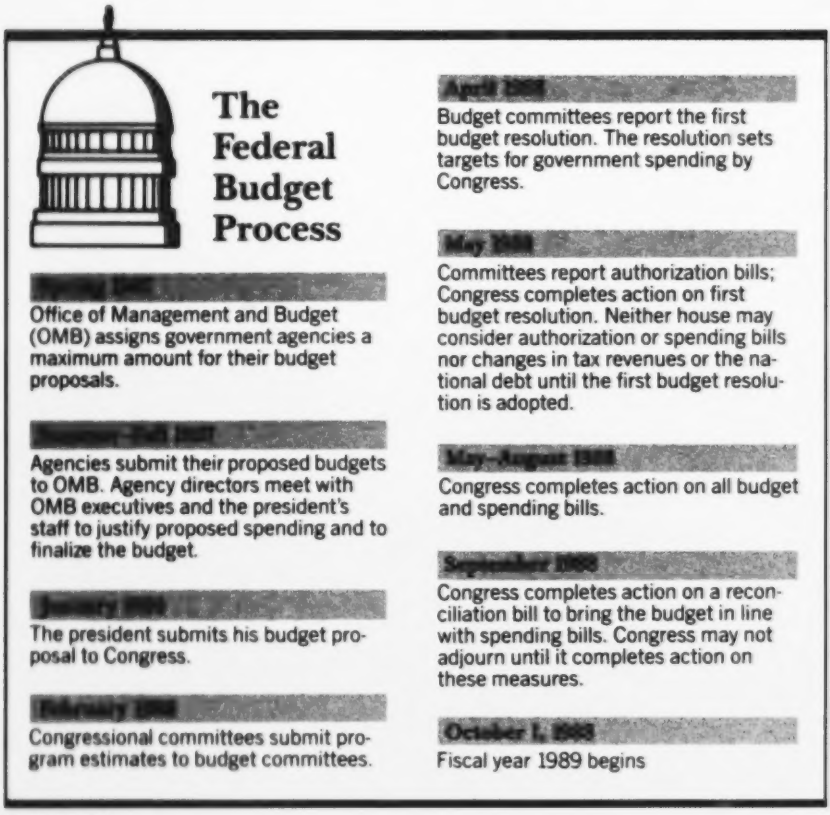

The Federal Budget Process
Office of Management and Budget (OMB) assigns government agencies a maximum amount for their budget proposals.
Agencies submit their proposed budgets to OMB. Agency directors meet with OMB executives and the president's staff to justify proposed spending and to finalize the budget.
The president submits his budget proposal to Congress.
Congressional committees submit program estimates to budget committees.
Budget committees report the first budget resolution. The resolution sets targets for government spending by Congress.
Committees report authorization bills; Congress completes action on first budget resolution. Neither house may consider authorization or spending bills nor changes in tax revenues or the national debt until the first budget resolution is adopted.
Congress completes action on all budget and spending bills.
Congress completes action on a reconciliation bill to bring the budget in line with spending bills. Congress may not adjourn until it completes action on these measures.
Fiscal year 1989 begins

FIGURE 3.3

the National Cancer Institute wants to show that curing cancer is vital to the public health and that its research and educational efforts help reduce the number of deaths caused by cancer. The Department of Interior wants to show that protecting endangered species is an important national goal and that its Office of Fish and Wildlife Service has developed effective programs that deserve continued financing.

Agencies present their cases to Congress through hearings, through regular written reports, and by answering congressional requests for information. Sometimes more public techniques are the most effective, such as a ploy called "the Washington Monument game." For example, when Congress threatens to cut the National Park Service's budget, the Service says mournfully that cutbacks will force the closing of a popular tourist site, such as the Washington Monument. To avoid such an unpopular result, Congress restores

the Park Service's funds. Other agencies have their own variations of this tactic.

Interest Groups. Citizens with a common interest organize to give themselves a political voice. Interest groups are heavily involved in the federal budget process, lobbying members of Congress on a wide range of issues. On some issues, the group with the loudest voice is the most persuasive. On other issues, Congress listens to interest group needs, but ultimately rejects their position. Every member of Congress is likely to hear a variety of points of view from a variety of interest groups.

Today, more than 10,000 paid representatives work in Washington, D.C., to influence the legislative process. With the recent emphasis on spending cuts, interest groups have increased their efforts to present their views on how every proposed budget cut would affect them. For example:

- the American Association of Retired Persons fights attempts to cut Social Security and Medicare benefits;
- Vietnam Veterans of America tries to protect medical benefits for Vietnam veterans;
- the National Farmers Organiza-

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tion defends farm subsidy and rural loan programs;

- the Sierra Club works to protect environmental and wildlife preservation programs;
- the American Federation of Government Employees works to avoid cuts in the number of government employees and their benefits; and
- the National Taxpayers Union supports cuts in the federal budget to avoid the need for tax increases.

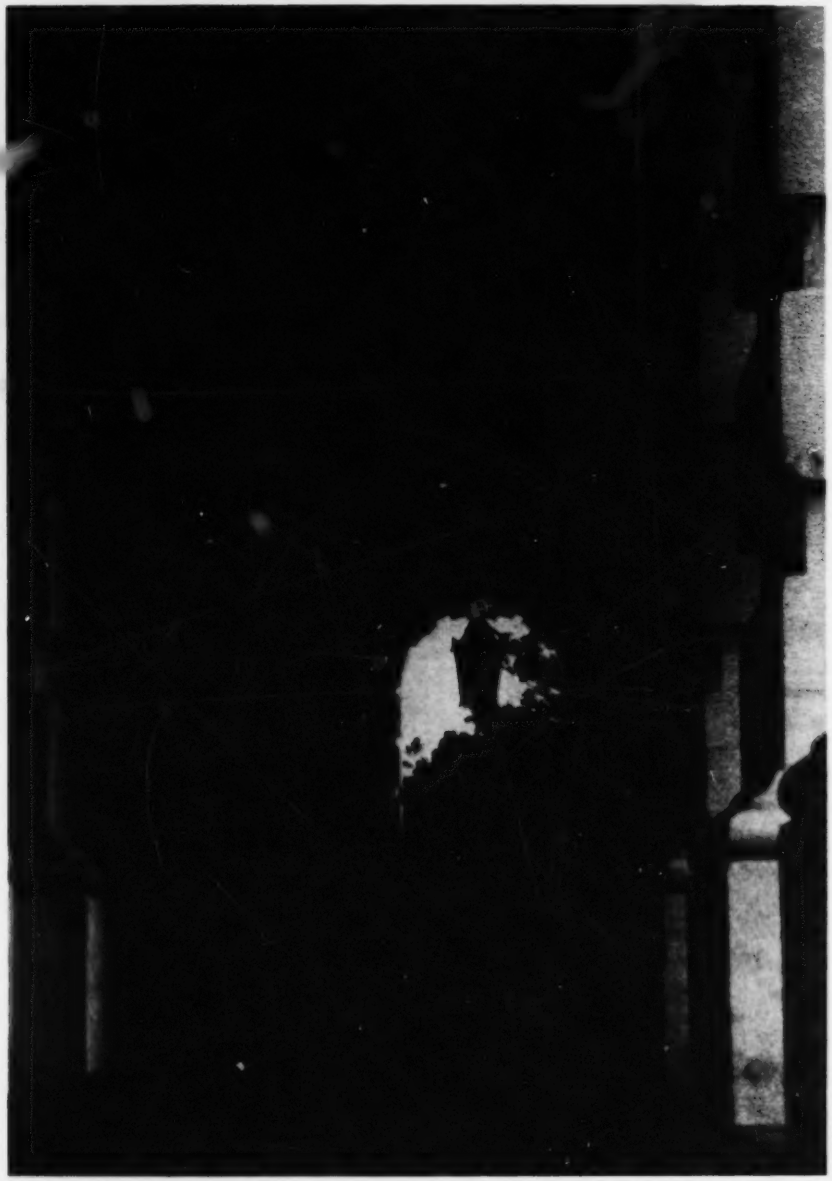
Domestic policy is not the only stage for interest group politics. Foreign policy issues also prompt lively debate. For example, many interest groups are also involved in foreign aid issues—such as economic aid to the Contras, military aid to our allies in the Middle East, and humanitarian aid to starving people in Africa—and national security issues—such as research on the Strategic Defense Initiative (SDI) and the upgrading of our nuclear forces.

Bringing It All Together: Congress

The role of Congress in the budget process is crucial. No government agency or program can operate without receiving approval and funding from Congress. In making budgetary decisions, members of Congress must balance the political agendas of the president, federal agencies, and interest groups. In addition to these pressures, members of Congress must also balance the needs of their constituents against the needs of the nation as a whole.

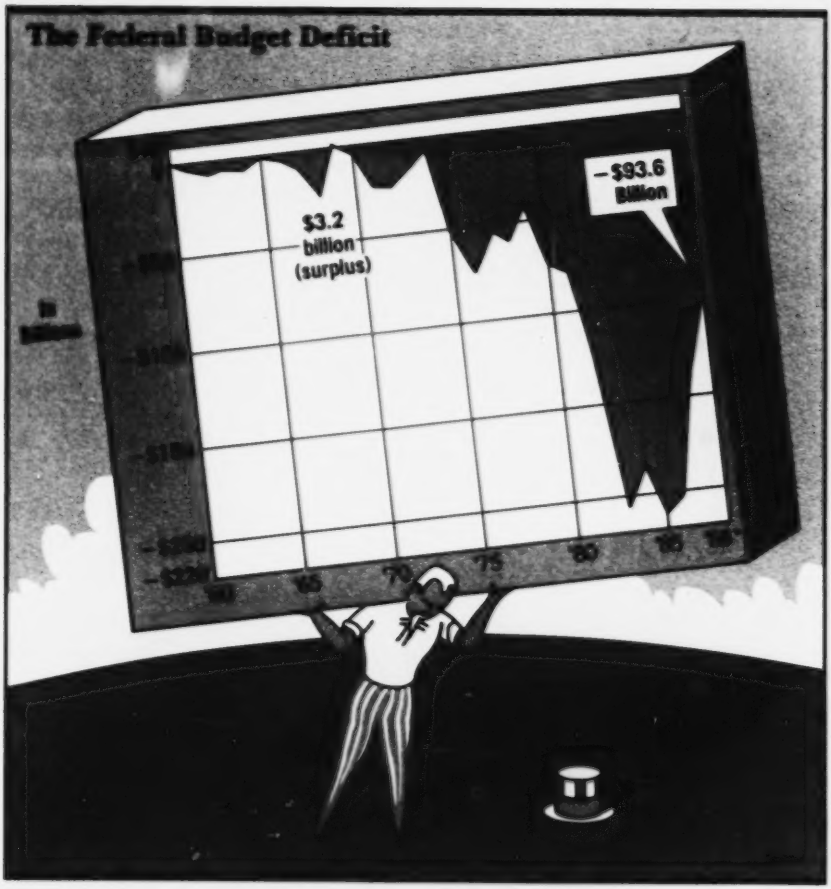
Defense spending is one issue where the needs of the nation may come into conflict with the needs of a senator or representative's home district. A decision to build a new weapon system can mean jobs and economic prosperity to congressional districts with defense contractors. For example, when Congress was debating the need for the B-1 bomber in the 1970s, two congressional opponents came from Wisconsin—a state with a strong dairy industry, but no defense contractors. It was easy for these members to oppose the funding of the B-1 bomber because their districts would not be affected. Commenting on the reasons for their opposition, one Pentagon official was quoted as saying, "It's a shame that we can't run the B-1 on milk." Conversely, a member of Congress from a district with defense-related businesses would have a hard time voting against the B-1 bomber—even if he or she believed that cuts in defense spending were needed to reduce the budget deficit.

It is a fact of political life that members of Congress have to be reelected every few years (two years for representatives and six years for senators). Among others, Senator Phil Gramm (R-Texas) has noted the difficulty of making an un-



Close Up Foundation

The president's budget often provokes intense congressional debate. With 535 individual members—each one seeking his or her own political agenda—budget decisions are a compromise.



Source: Office of Management and Budget and Statistical Abstract of the United States, 1986

FIGURE 3.4 ***The fastest growing part of the federal budget is interest on the national debt. In 1987, the government will pay more than $148 billion in interest payments on the debt, compared to $53 billion in 1980.***

biased budget decision when the folks who elect you have a financial stake in the outcome. "Every time you vote on an issue," Gramm said, "all the people who want the program are looking over your right shoulder and nobody's looking over your left shoulder . . . In being fiscally responsible under such circumstances, we're asking more of people than the Lord asks."

In addition, members of Congress sometimes "trade" their supportof one program for the support of other members on "their" issue. Consequently, budget decisions are

not always based solely on the merits of a program. Throughout the budget process, members of Congress must weigh the needs of the nation as a whole against the views of the president, federal agencies, interest groups, and constituents. Ultimately, budget decisions are a compromise among competing players. Those decisions have a profound effect on the nation's economy.

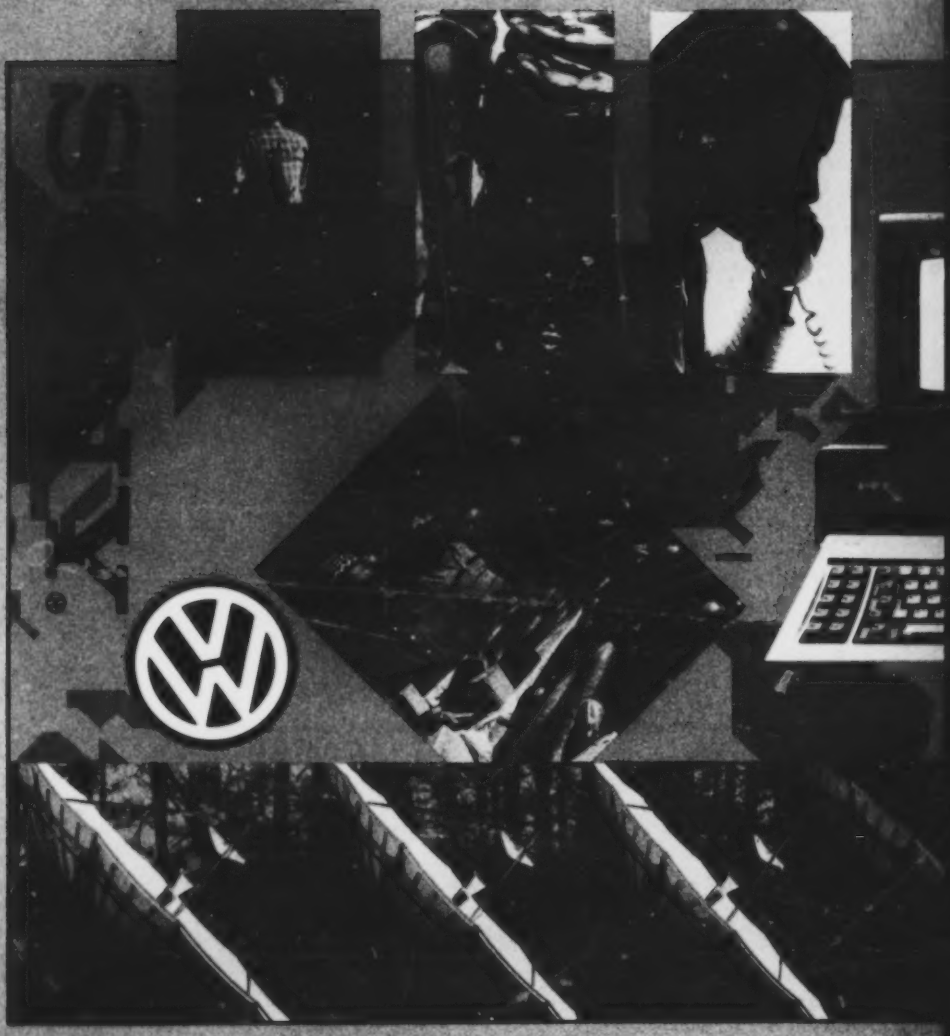
Can America Afford American Values?

Pursuing our social values through government programs has cost the U.S. government an enormous amount of money. To a large extent, the government has paid for its programs with money it has borrowed rather than earned. As a result, the government now faces a national debt of more than $2 trillion (figure 3.4). And still the government has neither eliminated poverty or discrimination nor guaranteed the security of the United States against attack.

Since the Great Depression, the federal government has become more involved in the daily lives of citizens than ever before. Today, many say that government interference has become a hindrance to the economic well-being of the nation. They have called for drastic reductions in government expenditures and deregulation of industry. Yet no one wants an America that turns its back on human need.

Today, political decisions are economic decisions. The challenge for decisionmakers—and the nation—is to find a way to balance our social values with the realities of the national debt.

4 Today's Choices, Tomorrow's Legacies



When productivity rises, the change inherently eliminates some work that people used to do, whether as milkmaids or welders. Thus a more productive economy can be wonderful in the abstract and threatening in the concrete.

James Fallows

The United States is a leading player in the global economy. America controls one-quarter of the world market, producing more than 25 percent of all goods and services. For this reason, problems that we view as domestic can have worldwide repercussions. For example, a recession in the United States could trigger another country's depression, and the high cost of producing goods in the United States might mean that consumers in other countries could not afford to buy American-made goods. To ensure the economic health of their own economies, other nations pay close attention to economic trends in the United States.

The technological revolution of the past thirty years—including the development of computers, robots, satellites, and telecommunications—changed the way the world does business. America is no longer a nation of factories and farmers, of assembly-line workers and laborers. As the world moves into the "information age," entire new industries are developing. These changes have implications for us all.

The United States in the Global Economy

The United States emerged from World War II a global power. Our nation had escaped the war's devastation, and the billions of dollars it had spent on military production had revived the U.S. economy. The postwar era was one of prosperity, productivity, and economic growth.

To keep the U.S. economy booming, American manufacturers needed a worldwide market. The United States lent millions of dollars and gave technical assistance to Europe and Japan to help them rebuild. We also reduced tariffs and became a leading proponent of free trade. American leaders understood that if foreign factories were not rebuilt, those nations would have suffered from high unemployment, and therefore would have been unable to buy American goods.

For three decades, the United States remained the world's strongest economic power. But in 1973, the country suffered a sudden jolt. The Organization of Petroleum Exporting Countries (OPEC) put an embargo on oil shipments to the United States. At that time, im-

UPI/Bettmann Newsphotos

The OPEC oil embargo of 1973 had a tremendous impact on life in the United States. People had to wait hours in line to buy gas, and some parts of the country experienced severe shortages. The embargo demonstrated the economic interdependence of the United States with other nations.

ported oil accounted for one-third of the petroleum used by the United States. With less oil available, energy costs soared. Consumers, manufacturers—everybody was affected. The embargo demonstrated that the United States was vulnerable to the actions of other nations.

In the modern world, no nation acts in isolation. Just as the oil embargo had a tremendous impact on the economy of the United States, so do the policies of the United States have an impact on other nations. This concept, called *interdependence*, defines our economic relations with the rest of the world.

UPI/Bettmann Newsphotos

One out of every eight manufacturing jobs relates to products sold overseas. In the past decade, more than 2.5 million workers have lost their jobs to foreign competition.

Trade: The Global Link

The United States is the world's largest importer and exporter. Every year, Americans buy vast quantities of foreign-made goods, including food, clothing, and automobiles, which creates jobs overseas and keeps foreign workers employed. At one time, our economy was the "engine of growth" for the rest of the world.

But the health of our economy also depends on the health of the international economy. One out of eight American jobs is connected in some way with producing and exporting an assortment of items, from grain to computer software. During the 1980s, sales of U.S. products declined overseas. As a result, many American manufacturers laid off workers. More than 2.5 million workers have lost their jobs to overseas competition since the start of the decade.

Ironically, the United States helped create the conditions that caused its exports to decline. In the early 1980s, the United States faced two economic problems: high inflation and a sluggish economy. To reduce inflation, the Federal Reserve Board instituted a *tight money* policy, that is, it *reduced* the money supply. At the same time, the Reagan administration tried to stimulate the economy by instituting a tax cut, which *increased* the amount of money that consumers had to spend. However, the decrease in government revenue was not offset by a decrease in federal spending. As a result, the federal budget deficit soared to close to $200 billion a year.

How the Budget Deficit Affects Trade

Most experts believe that the huge federal budget deficit is a primary cause of the U.S. trade imbalance. To finance the budget deficit, the government borrows money from private banks. This borrowing decreases the amount of money available for small, individual loans such as loans to finance a car, house, or college tuition. This shortage of "loanable" money drives up U.S. interest rates (i.e., the amount of money people have to pay to borrow money).

Foreign investors like to invest their money in countries with high interest rates. They loan their money to U.S. banks because they earn a good return on their money. But to do this, they must first convert their currency into American dollars. Foreign demand for American dollars has been high for a number of years. The higher the demand, the more foreign investors are willing to pay in their own currency for dollars. And because investors are paying more for each dollar, the value of the dollar increases.

The high value of the dollar in turn drives up the price of American products sold abroad. Foreign consumers react to these high prices by buying fewer American-made goods. For example, if a pair of American-made blue jeans cost 20 French francs in the 1970s, a French teenager might buy two pairs. But if the same pair of jeans goes up to 40 francs, the teenager may only be able to afford one pair. Sales of U.S. blue jeans then drop,

REMEMBER THAT HUGE, MYSTERIOUS OBJECT, THE MOST MASSIVE KNOWN IN THE UNIVERSE? I THINK WE'VE IDENTIFIED IT!
Don Wright, The Miami News

and American jean companies earn less money on their exports and have to lay off workers. This same process is repeated hundreds of times over in other industries.

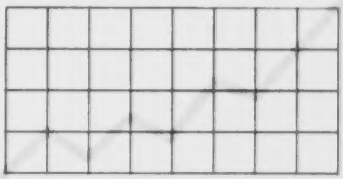
On the other hand, the high value of the dollar reduces the cost of imported goods in the United States. American consumers have taken advantage of these low prices by buying fewer American goods and more foreign goods. This has led to declining domestic profits and employment.

What's Happening in America?

One of the key issues for America's long-term economic outlook concerns a fundamental shift in the structure of the nation's economy. Heavy manufacturing industries, such as steel and automobiles, now face stiff competition from abroad. Unemployment has risen rapidly in these industries, to the point where manufacturing is no longer the largest employer in the American economy. The undermining of the nation's industrial base has implications for workers in all fields.

Emergence of Foreign Competition

American and foreign consumers now buy more foreign than American products in some product categories. As sales of U.S. goods decline, U.S. industries lose profits



Why Is Economic Growth Desirable?

Most economists agree that growth is an important part of any economy. In the United States, Americans have had a strong belief in the need for growth for three reasons.

First, when the economy grows, employment opportunities are created and salaries increase. More Americans have jobs, and they can afford more and better material comforts—bigger homes, more appliances, more entertainment, and better clothing.

Second, a growing economy means that a large number of taxpayers are paying larger amounts of taxes. This increase in revenue gives the government more money to spend on social services and national defense.

Third, a growing economy makes us more competitive in the world marketplace. High productivity means that more people are producing more goods in less time. A rising rate of productivity usually leads to higher wages, higher profits, and lower prices.

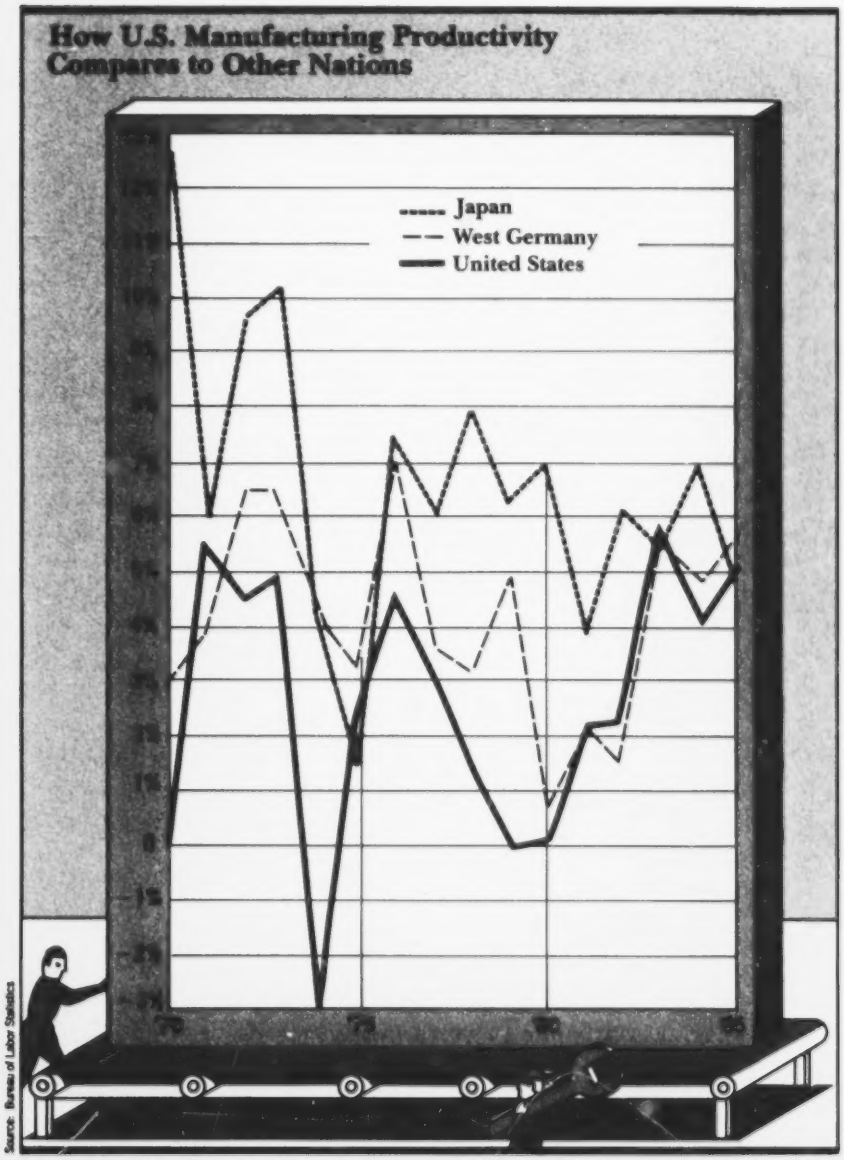


FIGURE 4.1 ***Productivity is one measure used by economists to measure the health of a nation's economy. U.S. policymakers are concerned that high productivity in other nations such as Japan and West Germany has given foreign manufacturers an edge over American manufacturers in the international market.***

and employment falls. Increased unemployment means even less demand for U.S. goods, and U.S. productivity (the amount of goods produced per man-hour) falls even more.

Economists believe that productivity and economic growth are essential to the economic well-being of our nation. From 1980 to 1985, total productivity in the United States rose 6 percent; while in West Germany it climbed 10 percent; and in Japan it jumped 16 percent (figure 4.1). Foreign countries are producing higher quality goods more cheaply.

Analysts say that the growth in foreign productivity has occurred for several reasons.

- Foreign companies have been more willing to invest in newer, more efficient manufacturing techniques, while U.S. companies have lagged behind. For example, in 1982, less than one-third of U.S. steel was produced by the most modern method (continuous casting) compared with four-fifths in Japan.
- Foreign companies benefit from strong government planning. For example, the Japanese government makes decisions about which industries have the most potential to grow (called "sunrise" industries), then directs investors to invest in those companies. Many analysts believe central government planning has given Japanese industries such as electronics and computer technology an advantage in international competition.
- Workers in other nations are willing to work for lower wages than are American workers, especially in unionized industries. For example, in South Korea, the average wage for steel workers is $3 an hour, while in the United States, the average wage is $23.47 an hour.

The companies most affected by foreign competitors have been in the steel, automotive, and textile industries.

The Domino Effect

In the United States, the health of one manufacturing industry is integrally linked to many others (figure 4.2). A problem in one industry—such as a prolonged strike or the success of a foreign competitor—can cause problems in other industries. For example, in the 1970s when U.S. auto sales declined, many other supporting industries were also affected: steel (automotive body, screws, nuts, and bolts); electronics (electrical wiring, radios); plastics (knobs, switches, dashboards); textiles (upholstery, carpeting); glass (windshields, windows); rubber (tires); and paint (interior, exterior). As company executives were forced to cut production and lay off millions of workers,

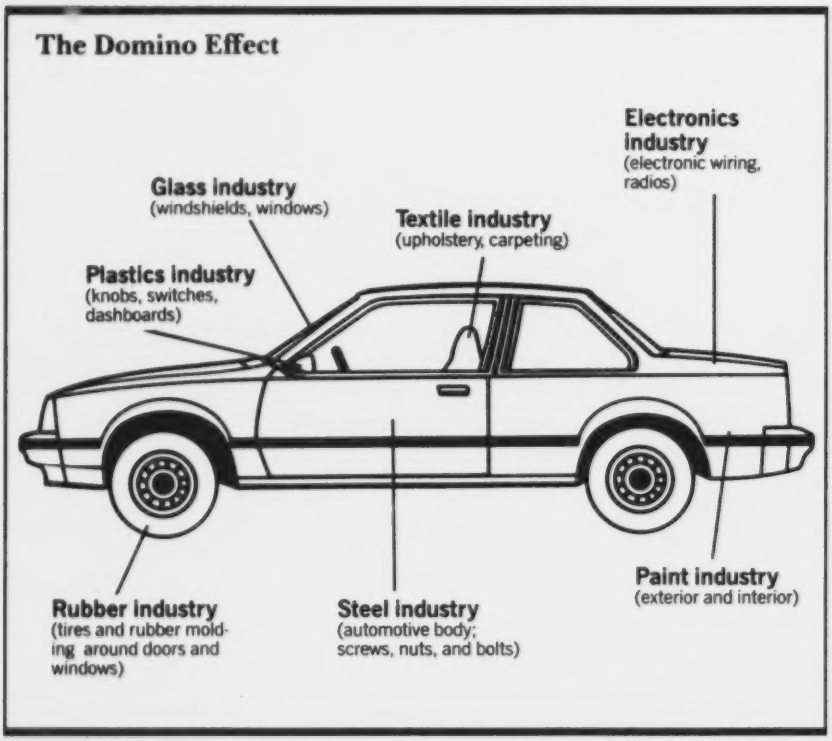


FIGURE 4.2 ***In the United States, the health of one manufacturing industry is integrally linked to many others. For example, the recent rise of foreign car sales in the United States hurt U.S. automakers and the many other industries that support them.***

their actions had a domino effect on the entire nation.

Displaced Workers. The most emotional issue regarding the emergence of foreign competition is what happens to employees when a manufacturing plant closes. Some companies have failed to give employees agreed-on pensions, and final paychecks have "bounced" and medical insurance has been cut off immediately. Unemployment insurance and union benefits have helped some families through the immediate crisis, but few industrial workers have the skills to do another kind of work. Many industrial workers have been with companies for twenty to thirty years and have difficulty starting over in another field. What happens to the steel worker in Pittsburgh when all the steel mills in town are closing?

The Future of Manufacturing Cities. The decline of industrial manufacturing has had a profound ef-

fect on the cities of the north and northeast, where most of the nation's factories are located. As unemployment rises, the city's tax base falls. Important services like education, police and fire protection, mass transit, parks and recreation facilities, and sanitation services get shortchanged. Roads, bridges, and buildings decay because there is no money to maintain them. As the cities become less "liveable," individual businesses and workers may move to find a better environment. The cycle of decline continues.

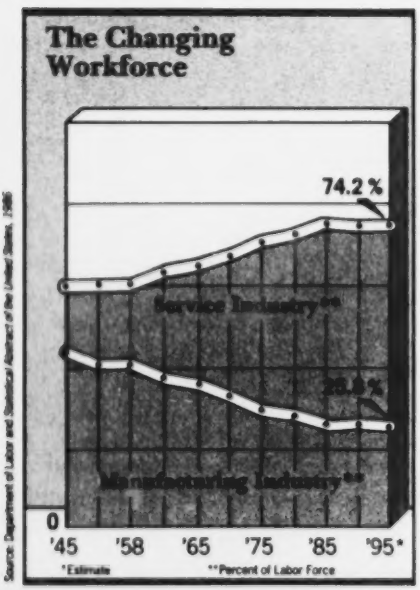
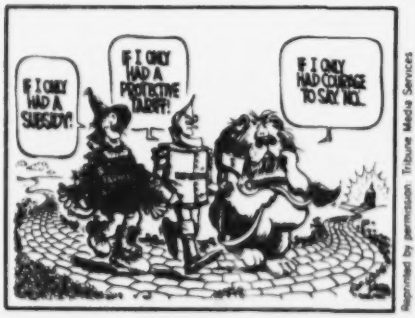


FIGURE 4.3 ***Since the end of World War II, more and more Americans are employed in the service industry. People in the service industry include teachers, health care workers, accountants, computer operators, and restaurant employees, to name a few.***


IF I ONLY HAD A SUBSIDY!
IF I ONLY HAD A PROTECTIVE TARIFF!
IF I ONLY HAD COURAGE TO SAY NO.
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The Shift to a Service Economy

Manufacturing is no longer the largest part of the American economy. Today the service sector is the largest and fastest growing segment. More than 75 percent of American workers have jobs in which they provide services instead of make goods (figure 4.3). The service industry is broad—it includes doctors,lawyers, journalists, bus drivers, sales clerks, janitors, accountants, and restaurant workers, to name a few.

Coupled with this change in the workforce has been a population shift from the north and northeast to the south and west (figure 4.4). There are many reasons for this shift. Businesses are lured by the prospect of lower energy costs and lower taxes. People are lured by the prospect of available jobs, better climate, and year-round recreation. During the 1970s, 74 percent of all new jobs were in the Sun Belt. Experts estimate that by the year 2000, one out of five Americans will live in California, Texas, or Florida.

Looking Toward the Future

A short economic history of the United States would read: farmer, assembly-line worker, sales clerk. Since the founding of this nation, our economy has undergone three major shifts—from an agricultural nation to an industrialized nation to a service economy. But the third transition is not yet complete. The nation still suffers from high unemployment, decaying cities, and low productivity. Many people wonder if the United States can regain its stature as the world's leading economic power.

The problems our nation faces are serious. Decisionmakers have

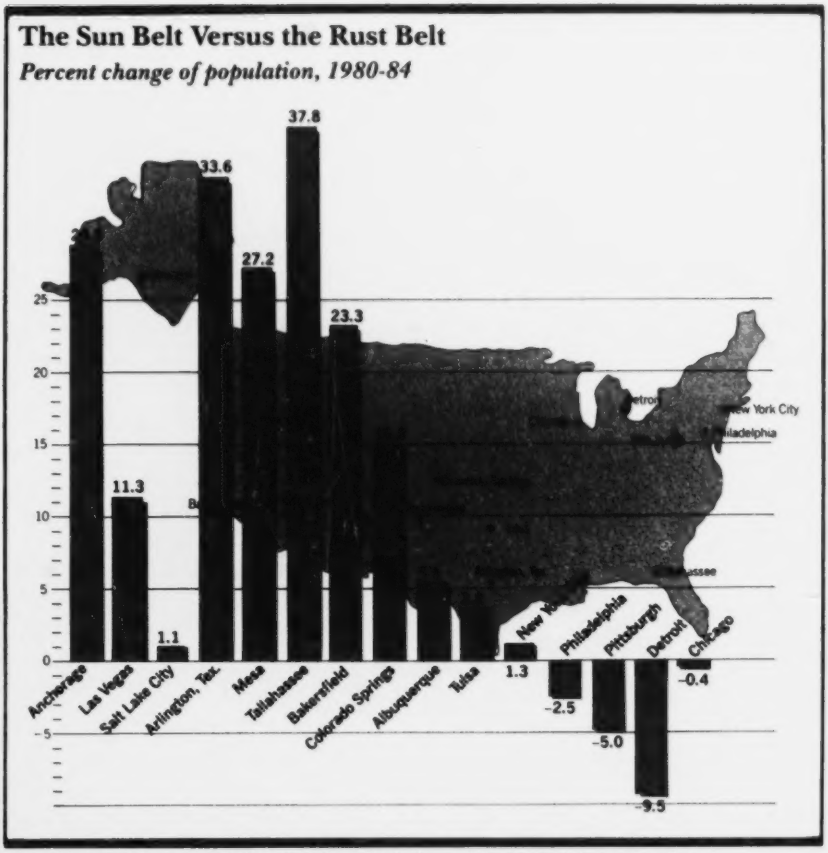

FIGURE 4.4 ***For several decades the population of the United States has been moving from the North and Northeast to the South and West. In 1984, the ten fastest growing states were Alaska, Nevada, Utah, Florida, Texas, Arizona, Colorado, New Mexico, Oklahoma, and Wyoming.***

U.S. Department of Housing and Urban Development

Northern industrial cities such as Boston, Chicago, and Detroit have recently begun to bounce back after an economic slump. City governments have adopted aggressive economic policies—such as tax breaks, office-rent subsidies, and rezoned downtown areas—to lure high-tech firms into their region.

suggested a variety of solutions—including job-retraining programs, worker relocation, urban renewal projects, the development of a national industrial policy, and changing the nation's trade policy. In the past, Americans looked to the federal government to solve its social and economic ills. However, in the face of a $2-trillion national debt, many question what role the government can realistically play.

The Reagan administration is committed to reducing the role of the government in the economy. The administration believes that the future economic well-being of the nation lies in the private sector. It is the private sector that will create jobs, raise productivity, and restore America's competitive edge in the world marketplace.

Americans are accustomed to a nation of wealth and prosperity. For years, Americans have viewed themselves as "number one"—politically, militarily, and economically. America's business ethic defines success as expansion—from a small corner store to a nationwide chain. America's self-image is being tested. The choices we make today will have far-reaching effects, not only on the economic health of the nation, but also on our national identity.

Exploring Economics

Questions for Further Research

Chapter 1
Government's Role in the Economy

Understanding Economics

A nation's economic policy is based on the concept of *scarcity*, that is, the fact that there are not enough resources in a nation to satisfy the needs and wants of the people. What a nation has and what it wants or needs has a tremendous impact on its relations with the rest of the world. For example, the United States does not have enough oil to satisfy its needs, so it tries to maintain friendly relations with oil-producing nations of the Middle East. Nations of the Middle East look to the United States to provide them with high-technology items such as manufacturing equipment, industrial machinery, and aircraft engines and parts.

How does a nation go about meeting its needs? Throughout history, nations have sought friendly relations with other nations; formed economic alliances; negotiated trade agreements; imposed tariffs, quotas, and other forms of trade barriers; experienced internal revolution; and fought wars—all to get what they deem as essential to the survival of their nation. Explore how the concept of scarcity has affected national and international affairs. How have individual policymakers dealt with economic scarcity?

Economics and You

The United States, the Soviet Union, and Great Britain have developed different types of economic systems to meet the needs of their people. How are these economic systems similar? How are they different? What does each economic system tell you about the values and economic goals of that nation? How is your life different because you live in the United States?

Chapter 2
How Government Affects the Economy

Understanding Economics

Since the 1930s, keeping the U.S. economy stable has been a primary goal of the federal government. In the postwar era, policymakers have relied on the teachings of British economist John Maynard Keynes. According to Keynes, businesses and consumers did not have the resources to correct problems in the economy. He believed that government should stimulate the economy by increasing government spending. Government should put money into the hands of consumers by creating job programs, thereby increasing demand for goods and services. With increased demand, production would increase, more jobs would be created, and consumer spending would revitalize the ailing economy.

In 1981, Ronald Reagan brought a new economic philosophy—supply-side economics—to the White House. Supply-siders believe that the way to stimulate a sluggish economy is to increase the supply side of the economic equation (i.e., pump more money into the economy) by cutting taxes and reducing government spending. With more money to spend and invest, businesses would expand, producing more goods and services and creating jobs.

Since its inception, supply-side economics has been controversial. Do you think that supply-side economics is a viable solution to the nation's economic problems? Do you think that the way to solve economic problems—such as unemployment—is through tax cuts or government-funded job programs?

Economics and You

Since the late nineteenth century, the federal government has been actively regulating the conduct of business in the United States. For example, the government prohibits unfair business practices, establishes product safety standards, ensures safe working conditions, and regulates interstate commerce.

Today, many people are critical of government regulation of business. They claim that the government hinders business with needless rules and bureaucratic red-tape. How does government regulation of business affect you? Consider the government's involvement in the areas of food, medicine, and automobiles. Do you think that government regulation is necessary? Or does it hinder free enterprise?

Chapter 3
American Values and Economic Policy

Understanding Economics

Thousands of bills are introduced into Congress every year. Sometimes the economic consequences of a bill are clear, such as when Congress decides to fund a new defense program. For example, congressional approval of research funds for the Strategic Defense Initiative (SDI) will generate government contracts to engineering firms, university research departments, and weapon manufacturers. The funding of SDI will mean jobs for scientists, engineers, and contract administrators across the country.

Sometimes the economic consequences of a political decision are not so clear. Suppose Congress decides to ban grain shipments to the Soviet Union in response to human rights violations. What would be the economic consequences of such a decision? Consider the United States, the Soviet Union, and other nations that export grain. Do you think there are any political decisions that do not have economic consequences?

Economics and You

Chapter 3 discusses three values that are reflected in the federal budget. What other values must policymakers consider in deciding national spending priorities? Which values do you think are most important? Do you think the government can continue to fund its programs *and* balance the federal budget?

Chapter 4
Today's Choices, Tomorrow's Legacies

Understanding Economics

National economic planning is one of the primary issues facing the United States today. Whole industries are no longer competitive in the world market. Plant closings, massive layoffs, and declining profits have forced U.S. business executives and policymakers to reexamine America's way of doing business. Some economists are advocating that the United States adopt a *national industrial policy*—such as that in Japan—to solve the nation's economic ills. They say that a *planned* economy would be much more efficient than an *unplanned* economy. A national industrial policy might include: job retraining, worker relocation, protectionist policies for heavy manufacturers, and government support of high-tech industries.

Others say that a national industrial policy is little more than a centrally planned economy. They point to the inefficiency of communist nations—such as the Soviet Union and the People's Republic of China—in which the government controls where people work, how much money they make, and how many goods they must produce. It is our system of free enterprise that has made our nation prosper, and it is this same system that will solve our current economic problems. American industry should not look to the government for help. The private sector must restore America's competitiveness in the world market—without government interference.

Do you think the United States should establish a national industrial policy? Does the government have a responsibility to "save" ailing industries? Does the government have a responsibility to retrain workers for high-tech jobs? Do you think it is fair to expect U.S. industries to compete by free-market rules when other nations do not?

Economics and You

How do your spending habits affect the national economy? Simple everyday decisions — such as whether to purchase a shirt made in Hong Kong or the United States, a radio made here or abroad, or an automobile made in Detroit or Japan—can have a tremendous impact on our nation's economic health. In the end, it is the individual and collective decisions of members of society that determine America's economic well-being. How will the economic choices you make today affect the economy of tomorrow?

Glossary

BALANCE OF TRADE
Difference between a nation's imports and exports. When exports exceed imports, the balance of trade is in a *surplus*; when imports exceed exports, the balance of trade is in a *deficit*.

CAPITALISM
Economic system based on private ownership of property, production of goods for profit, and competition among producers. Prices and wages are generally, but not always, related to the supply of and demand for a particular good or service.

COMMUNISM
Economic system based on the principle of communal ownership of property, and distribution of goods and services based on each person's need.

COMPARATIVE ADVANTAGE
Those characteristics of a nation (such as location, climate, skilled labor, or technical superiority) that enables it to make certain products at a lower cost than other countries do.

CONSUMER GOODS
Products that satisfy people's economic needs and wants. Food, clothing, and automobiles are examples of consumer goods.

DEFICIT
Amount by which spending exceeds revenue.

DEFLATION
General decline in prices and wages resulting in an increase in the purchasing power of the dollar.

DEMAND
Quantity of a good or service that consumers will purchase at various prices. The factors that determine demand are income, taste, and the price of other goods.

DEMOCRATIC SOCIALISM
Economic system that combines state ownership of some industries with democratic principles such as free elections. Democratic socialism is practiced in Great Britain and France.

DEPRESSION
Prolonged slump in business activity marked by high unemployment.

DEREGULATION
Process of reducing governmental control of an industry or industries.

"EASY" MONEY
Result of an expansion of the money supply by the Federal Reserve Bank, giving more banks more money to lend. Easy money leads to increased demand and production. (See also **"TIGHT" MONEY**.)

ECONOMICS
Study of how people and nations use their resources to produce, distribute, and consume goods and services.

EMBARGO
A government order to prohibit trade with one or more nations.

EXPORT
To send goods from one nation to another. (See also **IMPORT**.)

FEDERAL RESERVE SYSTEM
The institution responsible for controlling monetary policy in the United States.

FISCAL POLICY
Government taxing and spending decisions.

GROSS NATIONAL PRODUCT (GNP)
Dollar value of *all* the goods and services produced during one year in one country.

IMPORT
To bring goods from one nation to another. (See also **EXPORT**.)

INFLATION
General rise in prices and wages resulting in a decrease in the purchasing power of the dollar.

INTEREST RATE
Price paid by businesses and consumers for using money secured through a loan.

KEYNESIAN ECONOMICS
Theory developed by John Maynard Keynes that supported an active role for the federal government in maintaining a healthy economy through taxing and spending.

LAISSEZ-FAIRE
French term for "leave it alone." In economic terms, *laissez-faire*

means that the economic system of a nation is controlled by the laws of supply and demand with minimal government interference.

LEGAL TENDER
Money that, according to law, must be accepted in payment of a debt. In the United States, currency (Federal Reserve notes, or paper money) is legal tender, but checks are not. (See also **MONEY**.)

MONETARY POLICY
Those actions of the Federal Reserve System that increase or decrease the money supply.

MONEY
Anything generally acceptable as payment for goods and services. (See also **LEGAL TENDER**.)

MONEY SUPPLY
Amount of currency in circulation; the amount of money people have to spend.

MONOPOLY
Exclusive control by one seller of a particular good or service.

NATIONAL DEBT
Accumulated deficits of the federal government. Currently, the U.S. government has a debt of more than $2 trillion.

PRODUCTIVITY
Efficiency with which goods and services are produced, as measured by the quantity produced per person per hour.

PROTECTIONISM
Trade policy that uses tariffs, quotas, or other restrictions to limit the amount of goods imported into the nation and therefore protects domestic industries from foreign competition.

QUOTA
Limit on the amount of goods that can be imported into a country within a certain period of time. (See also **TARIFF.**)

RECESSION
Period of slow economic activity marked by decreases in production, spending, and consumer demand, and increases in unemployment.

RESERVE REQUIREMENT
Amount of money commercial banks are required to keep on reserve with the Federal Reserve System.

RESOURCES
A person or thing used in making goods or providing services. There are three types of resources:

- *capital*—goods used to produce other goods, such as tools, machines, or buildings.

- *human*—the skills, talents, and knowledge that people use to produce goods and services.
- *natural*—raw materials such as land, water, oil, timber, iron ore, or coal from which goods are made.

REVENUE
Income received.

SCARCITY
Condition that exists because people want more goods, services, and resources than are available. Every society and individual must deal with scarcity, that is, they must make economic choices.

SUBSIDY
Money given by government to an industry, business, or foreign government. Subsidies can take the form of low-interest loans, cash payments, or tax breaks.

SUPPLY
Quantity of a good or service that producers provide at various prices.

SUPPLY-SIDE ECONOMICS
Theory that government can promote economic growth by encouraging business to increase the supply of goods and services. Government can encourage such increases through deregulation and the lowering of taxes.

TARIFF
Tax levied on imports to raise revenue or protect a domestic industry from foreign competition. (See also **QUOTA**.)

"TIGHT" MONEY
Scarcity of money that results when the Federal Reserve decreases the money supply. (See also **"EASY" MONEY**.)

TRADE POLICY
Government's plan on how it will conduct economic relations with other nations. Tariffs, quotas, and trade agreements are examples of the tools governments use in conducting trade policy.

UNEMPLOYMENT
The number of people available and looking for work who cannot find a job. There are four types of unemployment:
- *frictional*—unemployment that occurs when people are between jobs or entering the job market for the first time.
- *seasonal*—unemployment that results from weather-related changes in demand for certain products.
- *cyclical*—unemployment that occurs because of downturns in the economy.
- *structural*—unemployment that results from changes in the economy, making the skills of certain workers obsolete.

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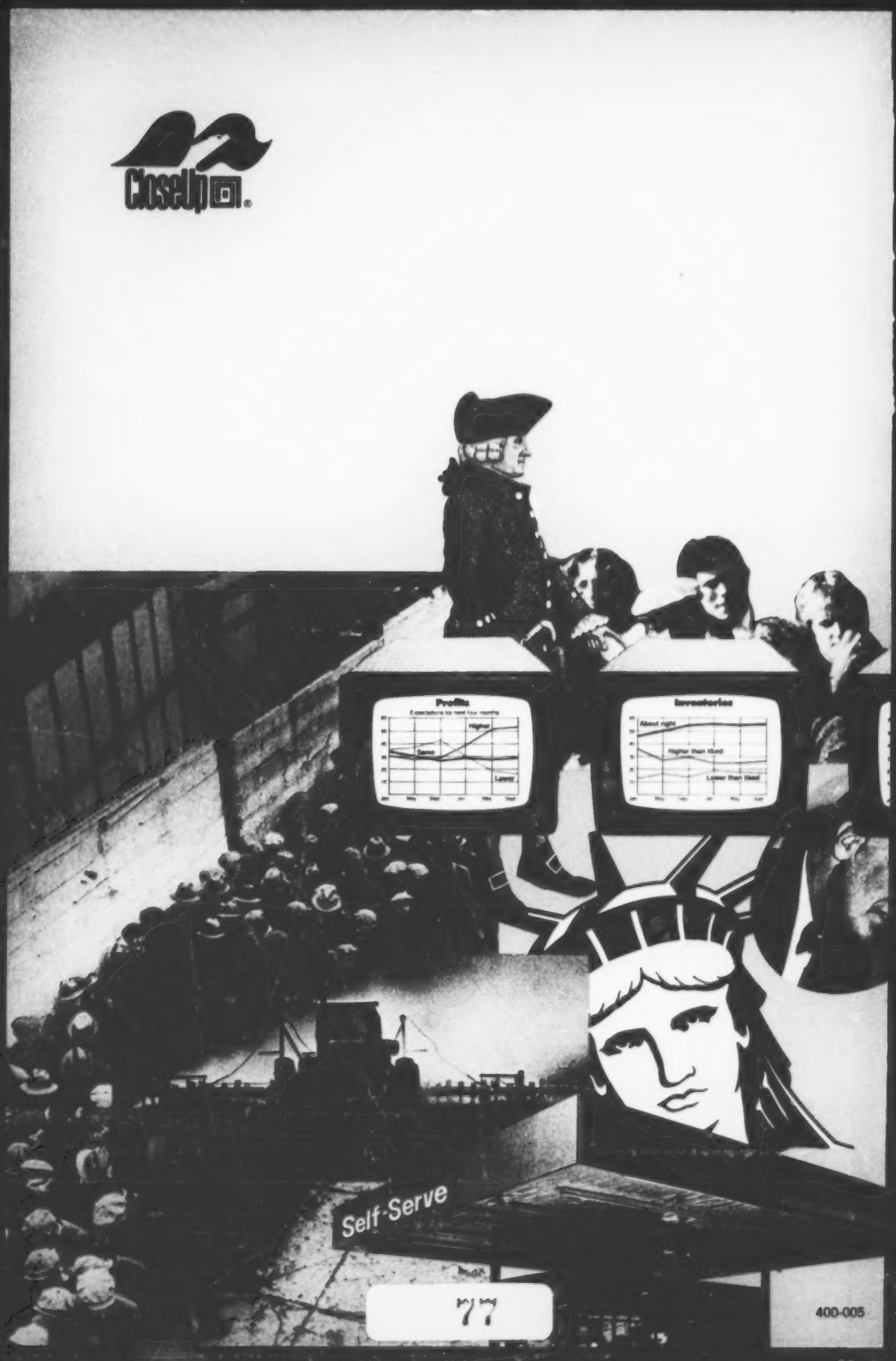
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